Session 24

Information Trading: Following the analysts

Test

1. Equity research analysts make earnings forecasts for the companies that they track, and revise these forecasts over time? Which of the following factors feed into earnings forecasts and subsequent revisions?
    a. New information from the company
    b. Earnings reports from other companies in the peer group
    c. Macroeconomic news about economic growth and inflation.
    d. Earnings revisions (for this company) made by other analysts
    e. All of the above
2. When the actual earnings are compared earnings estimates from equity research analysts, we have a measure of forecast error. Which of the following best summarizes the evidence on the quality of analyst forecasts?
    a. Analyst forecasts are perfect predictors of actual earnings
    b. Analyst forecasts are no better than time series models (which use only past earnings) at forecasting actual earnings.
    c. Analyst forecasts are better than time series models at forecasting actual earnings over any time period.
    d. Analyst forecasts are better than time series models at forecasting actual earnings over the near term (next quarter) but not over longer time periods (5 years).
    e. Analyst forecasts are better than time series models at forecasting actual earnings over the long term (5 years) but not over near term (next quarter).
3. Which of the following statements best summarizes the evidence on how markets react to earnings revisions made by analysts?
    a. Positive (negative) earnings revisions lead to an immediate increase (decrease) in the stock price and no subsequent drift.
    b. Positive (negative) earnings revisions lead to an immediate increase (decrease) in the stock price and prices continue to drift up (down) in the months after.
    c. Positive (negative) earnings revisions lead to an immediate decrease (increase) in the stock price and no subsequent drift.
    d. Positive (negative) earnings revisions lead to an immediate decrease (increase) in the stock price and prices continue to drift down (up) in the months after.
    e. Earnings revisions have no effect on the stock price.
4. Analysts make buy, sell and hold recommendations on the companies that they follow. Which of the following statements about recommendations is not true?
    a. There are far more buy recommendations than sell recommendations.
    b. Buy (sell) recommendations by analysts have a positive (negative) impact on the stock price

c. Sell recommendations have a much larger negative impact on stock prices over the long term than buy recommendations have as a positive impact in the long term.
d. Buy recommendations have a much larger positive impact on stock prices over the long term than sell recommendations have as a negative impact in the long term.

5. Assume that you plan to trade stocks, based on analyst recommendations. Which of the following strategies offers you the best odds of making money?
    a. Trade after all recommendations, buying after buy and selling after sell recommendations
    b. Trade after recommendations made by the analysts working at the largest investment banks (and ignore other recommendations)
    c. Trade after recommendations made by analysts that work at banks/brokerage houses that have no business relationships with the recommended firm (and ignore other recommendations).

Solution

1. Equity research analysts make earnings forecasts for the companies that they track, and revise these forecasts over time? Which of the following factors feed into earnings forecasts and subsequent revisions?
    a. New information from the company
    b. Earnings reports from other companies in the peer group
    c. Macroeconomic news about economic growth and inflation.
    d. Earnings revisions (for this company) made by other analysts
    e. All of the above

Explanation: Analysts have access to all of this information as well as informal hint/guidance from the companies in question that they can use to revise earnings estimates.

2. When the actual earnings are compared earnings estimates from equity research analysts, we have a measure of forecast error. Which of the following best summarizes the evidence on the quality of analyst forecasts?
    a. Analyst forecasts are perfect predictors of actual earnings
    b. Analyst forecasts are no better than time series models (which use only past earnings) at forecasting actual earnings.
    c. Analyst forecasts are better than time series models at forecasting actual earnings over any time period.
    d. Analyst forecasts are better than time series models at forecasting actual earnings over the near term (next quarter) but not over longer time periods (5 years).
    e. Analyst forecasts are better than time series models at forecasting actual earnings over the long term (5 years) but not over near term (next quarter).

Explanation: Analyst forecasts do better (albeit only mildly) than time series models at forecasting next quarter earnings, but not at forecasting longer term growth/earnings.

3. Which of the following statements best summarizes the evidence on how markets react to earnings revisions made by analysts?
    a. Positive (negative) earnings revisions lead to an immediate increase (decrease) in the stock price and no subsequent drift.
    b. Positive (negative) earnings revisions lead to an immediate increase (decrease) in the stock price and prices continue to drift up (down) in the months after.
    c. Positive (negative) earnings revisions lead to an immediate decrease (increase) in the stock price and no subsequent drift.
    d. Positive (negative) earnings revisions lead to an immediate decrease (increase) in the stock price and prices continue to drift down (up) in the months after.
    e. Earnings revisions have no effect on the stock price.

Explanation: Earnings surprises lead to a change in the stock price at the time of the announcement, which is consistent with the direction of the surprise. There does seem to be evidence that prices continue to drift in the same direction in the weeks following the announcement.

4. Analysts make buy, sell and hold recommendations on the companies that they follow. Which of the following statements about recommendations is not true?
    a. There are far more buy recommendations than sell recommendations.
    b. Buy (sell) recommendations by analysts have a positive (negative) impact on the stock price at the time of the recommendation.
    c. Sell recommendations have a much larger negative impact on stock prices over the long term than buy recommendations have as a positive impact in the long term.
    d. Buy and sell recommendations affect stock prices immediately but have no long-term impact on stock prices.

Explanation: Buy and sell recommendations do affect stock prices immediately, but there is also evidence that these recommendations (especially if they are sell recommendations) have a long term impact on the price.

5. Assume that you plan to trade stocks, based on analyst recommendations. Which of the following strategies offers you the best odds of making money?
    a. Trade after all recommendations, buying after buy and selling after sell recommendations
    b. Trade after recommendations made by the analysts working at the largest investment banks (and ignore other recommendations)
    c. Trade after recommendations made by analysts that work at banks/brokerage houses that have no business relationships with the recommended firm (and ignore other recommendations).

Explanation: Recommendations made by analysts who work at firms that have potential conflicts of interests (which is more likely to be the case with the major investment banks) are less informative than recommendations made by