When it comes to analysts, forecasting is a red herring

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Calculated risk: Analysts offer much more than forecasting skills according to Professor Imam. Credit: John Liu Flickr

It's not what you know, but how you tell it in the world of financial analysis according to new research.

The study suggests financial sell-side analysts' real skills sit not in the conventionally accepted idea of their recommendations, but in the information they provide to other industry analysts.

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Shahed Imam, of Warwick Business School, rejects the idea that forecasting is the primary function of analysts and suggests a varied skillset is more useful.

Dr Imam said: "In contrast to conventional wisdom and assumptions, the primary value of sell-side analysts' work lies not in the recommendations they ultimately produce, but in the rich contextual information that they provide to buy-side analysts.

"In order to successfully provide this information, analysts have to consume and interpret large amounts of technical knowledge. And in the end it is how they present it to clients that leads to success rather than their forecasts to buy, hold or sell a stock."

There are two types of financial analyst: sell-side analysts and buy-side analysts. Sell-side analysts work in equity research departments of investment banks.

Typically they generate and publish earnings forecasts, issuing buy, hold or sell recommendations and price targets. They also provide research reports available to investors, which can be accessed via various research databases such as Investext.

In comparison, buy-side analysts, also referred to as fund managers, work in fund management firms. They use information from sell-side analysts and elsewhere to support portfolio investment decisions. Like sell-side analysts, they also write reports for their employers. However, these are confidential and, as such, not publicly available.

For the paper, Context, not predictions: A field study of financial analysts, published in the Accounting, Auditing and Accountability Journal Imam, along with Crawford Spence, of Warwick Business School, interviewed 49 financial analysts - both buy-side and sell-side - in order to understand the work they do.

They wanted to answer the paradox: why do investors rely on analysts' work despite well-known inefficiency and bias in their forecasts? Similarly, they also wanted to answer the question as to why such analysts are valued in the market. Is it because of their quantitative skill or their prediction of numbers, or is there something else?

"We find that sell-side analysts play a complex and multifaceted role in the market that goes beyond merely forecasting. Indeed, forecasting is something of a red herring," said Dr Imam.

"They do this while maintaining a close relationship both with their clients to generate trade commission for their employers and with company management in order to secure preferential access to information sources.

"The assumptions underlying forecasts are more important than the forecasts themselves."

Feel for the game

Expertise still plays a very important role Dr Imam suggests, even if that expertise is ultimately never conducive to the construction of accurate forecasts.

As one analyst explained: "I build trust with sell-side analysts over time. I like those sell-side analysts who understand the businesses and who help me to understand the businesses. However, anything related to share price or price target… I don't believe them. I don't think they can add value there and I believe in my own way of doing it."

Most interviewees noted that buy-side analysts worked in an uncertain and highly competitive environment; they highlighted that stories from sell-side analysts played a key role in giving buy-side analysts a competitive advantage, not how accurate their forecasts were, although producing consistently inaccurate forecasts would erode the reputation of an analyst.

"Ultimately, what buy-side analysts are looking for is the multifarious skillset of the weather forecaster who can describe the interaction of different events, not precise predictions about where it will rain tomorrow," said Professor Spence.

"A well-developed analyst with all the facts and knowledge at their fingertips allows them to have a 'feel for the game' which clients appreciate rather looking for an accurate forecast."

"Social capital is very important here, not only for gaining access to management itself, but because having access to management creates an opportunity for sell-side analysts to promote themselves to buy-side analysts."

Provided by University of Warwick