AXIS CAPITAL

India Strategy

Dark Matter #2– Do analyst rating changes impact returns?

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In this second part of the Dark Matter series (in #1, we discussed the impact of seasonality (link)), we discuss the impact of rating changes by sell-side analysts on market performance. On aggregate, analyst rating changes do not correlate with market returns, but we find evidence of stock reactions on sharp rating changes. The reactions are more likely during downgrades, and higher for stocks that are covered by at least 10 analysts (mostly large-caps). The impact on returns is also most dominant during the month of rating change. The trend is visible across sectors, but behaviors change; IT/Discretionary react more on downgrades, but Staples/Pharma react more on upgrades. Most sectors see higher instances of sharp downgrades vs upgrades.

Exhibit 1: Assessing impact on market returns during sharp rating changes (0.4 point+)

	Upgrade count	Outperformance % times of reaction	Downgrade count	Underperformance % times of reaction
Aggregate	193	54%	243	63%
Large	67	58%	83	64%
Mid/Small	126	52%	160	63%
>10 Recommendations	62	73%	115	69%
<10 Recommendations	131	45%	128	59%
Disc.	19	53%	27	70%
Staples	6	83%	11	73%
Financials	45	53%	40	70%
Health	6	83%	14	57%
Industrials*	45	62%	51	65%
IT	15	33%	25	72%
Materials	16	63%	30	63%
Utilities	32	63%	29	66%

Source: Refinitiv, Company, Axis Capital; * Market reactions for Industrials are for 1 month after ratings changes

Market reactions highest on sharp rating downgrades; usually short-term

We find that overall market returns do not correlate strongly with every change in analyst ratings, given the rating changes are usually gradual and thus do not necessarily possess any new information on the stock or the sector. On the other hand, market returns tend to be volatile. However, we find evidence of unusual market reactions on significant rating changes (0.4 points or more), driven by either sharp rating changes by a few analysts or rating changes by multiple analysts at the same time. Market returns during the month of rating change tend to be more consistent in the case of downgrades as against upgrades, and reactions are most dominant during the month of rating change.

Ratings impact performance more for stocks with higher analyst coverage

Market reaction induced by rating changes is more evident for stocks that have higher analyst coverage (>10 analysts), with 73% instance of aligned returns vs 44% for less-covered stocks in the case of rating upgrades, and 70% for rating downgrades for more-covered stocks vs 59% for less-covered. This is likely due to the greater likelihood of new information behind rating changes for a more-covered stock. Similarly, performance impact due to rating is more evident for large-cap stocks compared to mid-caps.

Staples/Pharma react mostly on upgrades, but IT sees higher on downgrades

Financials is the 'most-favored' sector by sell-side analysts and saw the highest average sector rating in the past seven years. However, individual stocks have seen 85 instances of sharp rating movements, with 40 cases of downgrades, of which 70% resulted in sharp stock reaction. Similarly, IT and Discretionary also see higher reaction on downgrades vs upgrades. On the other hand, sectors like Staples and Pharma react higher on sharp upgrades, which are also rarer in these sectors compared to others.

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