LSE Business Review: Thinking of becoming an equity analyst? Get relevant industry experience first

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Sell-side equity analysts provide research coverage on a portfolio of firms (typically between 10 and 15) and disseminate their research in the form of earnings forecasts and stock recommendations to clients to help them make investment decisions. The importance of industry expertise is often cited among practitioners as the most important characteristic an analyst can possess and consistent with the observation that most analysts' coverage portfolios are concentrated in one or few industries.

For instance, each year *Institutional Investor* ranks the top analysts in each industry based on survey results by buy-side institutions that use their services. In addition to analyst ranks, they also ask respondents to indicate the most important trait they seek in an analyst. For over a decade, industry expertise has been rated the number one aspect in every single year.

But how does one measure analysts' industry expertise? One obvious way (and one we control for) is to examine the amount of time an analyst has provided earnings forecasts and recommendations on firms in a particular industry. While seemingly intuitive, this measure would be highly correlated with the amount of analyst- and firm-specific forecasting experience an individual analyst will have. Instead, we take a different approach and consider whether or not an analyst worked before they became an analyst. To determine an analysts' work history, we manually collect analysts' entire employment backgrounds from *LinkedIn*.

Consider a hypothetical example to illustrate our statistical approach. Before becoming an analyst, John Doe used to work at Walmart before taking an equity analyst position at Goldman Sachs. John's coverage portfolio consists of 12 firms, of which 8 are in the retail industry and 4 are in the media industry. Thus, John has relevant industry experience with respect to the 8 firms in the retail sector, but does not have industry expertise for the 4 firms he covers in media. Does this industry experience help make John a better analyst? Our statistical tests compare analysts with no prior industry experience (i.e, they went to work immediately as an analyst following college) to those with related industry experience (i.e., John's coverage portfolio of retail companies) and those with unrelated industry experience (i.e., John's coverage portfolio of media companies).

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Our evidence clearly supports the notion that prior industry experience aids analysts' performance. Using regression analysis in a sample of over 100,000 earnings forecast revisions made by analysts over the 1983 to 2011 time period, we estimate that earnings forecasts of industry-experienced analysts are 3.6 per cent more accurate compared to other analysts. Market reactions to earnings revisions by analysts with similar industry experience to their coverage firms are also more impactful. For instance, upward (downward) earnings revisions by analysts with industry experience are associated with market responses that are approximately 0.4 per cent (-0.5 per cent) greater.

In addition to their earnings forecasts, we also examine the performance of stock recommendations. Consistent with superior earnings forecasts, following the recommendations of analysts with industry relevant experience can be profitable. For example, we find that the stock recommendations of industry experienced analysts perform approximately 4 per cent better per year compared to inexperienced industry analysts

Since industry expertise helps analysts perform their job better, we analyse whether it helps advance their careers. Ideally, we would be able to tie job performance to salaries, but data constraints prohibit us from doing so. Instead, we proxy for analysts' career concerns using *Institutional Investor's (II)* annual all-star poll. Analysts strive to make this list because compensation is heavily tied to it. For instance, an academic study suggests that analysts that are rated as II all-stars enjoy more than a 50 per cent salary premium to non-stars. We find that analysts with previous industry experience are 43 per cent more likely to attain this stature.

Finally, we examine the real economic consequences of industry experienced analyst coverage on firms. Analyst coverage is sought by firms to improve their information environment, and, consequently stock price. When a firm loses analyst coverage, this information environment deteriorates and results in lower liquidity and price declines. We examine the negative impact of such losses of analyst coverage for firms that are covered by analysts with industry expertise to those that do not possess relevant industry experience. Losing analysts with industry expertise has a much greater negative impact on the firm than losing non-industry analyst experts.

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Notes:

- *This blog post is based on the authors' paper Before an Analyst Becomes an Analyst: Does Industry Experience Matter?, Journal of Finance, April 2017.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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