

Merrill Lynch's Focus Stock Picks: A Test of Analysts' Stock Picking Ability

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This paper tests the market reaction and the holding period performance of the recommendation by Merrill Lynch Corporation of a stock being placed on their focus stocks list. Being placed on this list indicates the stock carries a strong buy recommendation. We find the firms being placed on the list respond to the positive information by generating positive announcement date abnormal returns. We also find these abnormal returns on the two days prior to the announcement. The performance of the portfolio of all focus stocks results in insignificant holding period abnormal returns. Stocks remaining on the list for the initially recommended one-year holding period do beat the market. The stocks removed by Merrill Lynch prior to the recommended one-year period do not perform better than the market. Our results provide support for semi-strong efficient markets because investors cannot identify ex ante which stocks will be removed early.

Introduction

"Wall Street analysts have gone from darlings to dogs in just a few years." This quote from the June 2002 (page 71) of *Money* magazine captures the attention currently directed toward security analysts. Among the investment firms receiving the greatest attention is Merrill Lynch Corporation. This interest in security analysts in general, and Merrill Lynch in particular, emphasizes the importance of research aimed at stock recommendations provided by Merrill Lynch security analysts.

Our research looks at a group of common stocks recommended by Merrill Lynch Corporation. The specific recommendations evaluated are the weekly focus stock selections. We address the issue of the value added by purchasing these common stocks based on the advice of Merrill Lynch Corporation's analysts and management. Our analysis of the value of analyst information is tied to security

selection, market timing, and efficient market issues. That is, can an investment advisor consistently pick specific securities for a specified time horizon so that the total return is in excess of what could be earned by buying an appropriate market index?

Being placed on the focus stock list by Merrill Lynch signals that the stock is a strong buy with an initial suggested holding period of one year. We find that the market interprets the inclusion of a stock as containing positive news, as reflected in the abnormal positive announcement date returns. Over the course of the one-year holding period individual investors forming a portfolio by purchasing each of the recommended stocks would not be able to beat the market. To outperform a buy-and-hold index, the investor would have to know *ex ante* the identification of firms that Merrill Lynch will remove from the list prior to the end of the one-year holding period. This early removal occurs in about one-half of the initially included stocks. Our results also provide some evidence for the possibility of information leaking prior to the announcement of the recommendation.

This research makes several contributions. To our knowledge, this Merrill Lynch data set has not been academically tested for performance. Because Merrill Lynch is the largest U.S. brokerage firm, one would expect that the firm would be able to identify undervalued stocks as well or better than other firms providing buy recommendations. By testing this data set we are also taking a careful look at the efficient market hypothesis. If markets are (semi-strong form) efficient, then the extensive expenditures Merrill Lynch puts into investigating and recommending the focus stock of the week are, on average, superfluous unless the objective is just to raise commission revenues to exceed this outlay.

Most studies of analysts' recommendations focus on the buy-hold-sell advice. In our study, none of the stocks move from one category to another. These are all single stocks that are initially recommended as a strong buy. Not only are the stocks recommended for purchase, but also the holding period for these stocks is established at the time of the recommendation. At the end of the holding period the stocks move directly to the sell category. The existence of this focus stock list is a statement by Merrill Lynch that the firm can engage in both security selection and the timing of that selection.

The importance of the contribution of security analysts extends beyond the academic arena. The popular press heightens this debate by highlighting the performance of analysts and investment advisors. The *Wall Street Journal* does an annual report on analysts and even places a select group of them in an all-star category. The October issue of *Institutional Investor* magazine provides an annual ranking of individual analysts and corporate teams based on a survey of money managers. The fact that these lists exist implies some value to readers in identifying the analysts who achieve the best results. Given the interest and importance of investment advice, it seems imperative that researches continue on the value added to

investors from advisor recommendations. An interesting point related to our research from the *Institution Investor* surveys (1999, 2000) is that Merrill Lynch has ranked as the number one all-American research team for six of the past seven years (Merrill Lynch tied Morgan Stanley for first place in 2000).

Literature on Analysts' Performance

Chung (2000) tests whether analysts are an extension of the marketing arm of brokerage firms. By associating the preferences of brokerage clients with the number of analysts following a preferred firm he concludes "... financial analysts help the marketing efforts of brokerage companies by focusing their analysis on such stocks." In addition to Chung's marketing explanation, there have been other alternatives offered for the service that analysts perform. Brennan and Hughes (1991) provide support for analysts concentrating on stocks that generate the greatest commissions for the firm's brokers. Moyer, Chatfield, and Sisneros (1989) provide an agency-cost/monitoring explanation of the extending of analysts' efforts. The issue of the intent of analyst's recommendations remains an open question. Our research adds valuable insight into the benefit of analysts' recommendations. We do not resolve the issue, but the information gained here proves both interesting and potentially useful in this ongoing discussion.

Groth, Lewellen, Schlarbaum, and Lease (1979) and Womack (1996) find that analysts' recommendations do have significant event period and post recommendation positive abnormal returns. Groth *et al.* evaluate the recommendations of an individual brokerage house. They find that significant positive (negative) abnormal returns associated with buy (sell) recommendations are observed in the announcement month. Because there are no subsequent average abnormal returns and because the returns do not revert, they attribute value to the analysts' recommendations of this firm. They acknowledge the difficulty of most investors being able to exploit this information. One conclusion from the Groth *et al.* study is that the recommendations of a brokerage firm are "... genuinely valuable, even after allowing for transactions costs and risk" (Groth *et al.*, p. 32). Consistent with the Groth *et al.* results, Womack (p. 137) states "Analysts appear to have market timing and stock picking abilities."

Tests of the performance of buy and sell recommendations by analysts also have been conducted by Diefenbach (1972), Logue and Tuttle (1973), and Barber, Reuven, McNichols, and Trueman (2001). None of these studies identifies the brokerage firm. In each case, however, the recommendations are divided into *buy* or *sell* categories. All three studies conclude that transacting on the advice of the brokerage firms would not have resulted in superior performance. Random selection would have performed equally well or better.

Olson, Nelson, Witt, and Mossman (1998) test the relative strength and earnings per share rankings provided by *Investor's Business Daily* for their ability to serve as

filters for earning abnormal returns. They conclude that certain selection criteria using these two variables can be used to earn abnormal returns even after transactions costs. They also observe that firms identified as having expected high returns continue to earn some abnormal returns for up to 24 months following their ranking by *Investor's Business Daily*.

In testing this efficiency issue Value Line Corporation has been a frequent source of data for academics. Value Line claims that its stocks ranked number 1 for timeliness will outperform the market over the subsequent 12 months. The seminal academic study on the performance of Value Line ranked stocks was presented by Black (1973). A significant conclusion of the Black research is that Value Line's number one ranked stocks significantly outperform the market.

Other researchers have followed Black's lead. The conclusions from these studies on Value Line are mixed. Studies by Holloway (1981) and Copeland and Mayers (1982) conclude that return performance is enhanced by the use of Value Line recommended stocks. Holloway (1981) and Hall and Tsay (1988) find that for actively traded portfolios of the number one ranked stocks, any abnormal return performance is offset by trading costs.

Additional studies have looked at smaller areas of information implied by Value Line analysts, such as recommendations made in *The Value Line Special Situations Survey* (Pawlukiewicz and Preece, 1991), companies selected by Value Line for specific profile presentation (Chandy, Peavy, and Reichenstein, 1993), and firms that Value Line features as "Stock Highlights" (Peterson and Peterson, 1995). It is widely accepted that Value Line featured stocks convey some information that may be of material benefit to investors.

Merrill Lynch Focus Stocks

One of the many services provided by Merrill Lynch Corporation is in the area of investment advice to its clients. In order to enhance the performance of its clients, the company has created *focus stocks*. Each week the company highlights one stock that it predicts will perform better than average during the next 12 months. This one stock is the focus stock.

Personnel at Merrill Lynch corporate headquarters were reserved in disclosing details of the focus stock selection procedure. From discussions with several brokers and through reading Merrill Lynch documents, we were able to compile the following as the best description of the selection process. The identification of the focus stock is a joint effort including members of at least four committees within the company. The initial group of stocks to be considered by the selection committee comprises buy recommendations from the firm's analysts. The process is continued by the chief economist and market strategist who select a market sector that is expected to have a strong performance over the next year. Once the sector is communicated, input is received from committee members from three areas of the firm:

industry selection, fundamental analysis, and technical analysis. What the above process describes to us is a bottom-up approach to security selection.

Members of the committees meet on the Monday immediately preceding the Tuesday announcement. There is no standard time, length, or location set for the meeting. The focus committee must come to a unanimous decision on the stock to be recommended. If no consensus is reached, then no stock is recommended that week. The focus committee does not disclose the focus stock selected until after the close of the market on Tuesday. The stock that is chosen is communicated to Merrill Lynch financial consultants on Tuesday night after 4:30 through the Merrill Lynch computer system. On Wednesday morning consultants can listen to "Morning Call" available at 7:30 a.m. for updated information on the focus stock that was chosen. The stock automatically remains on the focus stock list for 12 months unless it is removed earlier by the selection committee or disappears through a purchase or merger transaction. Understandably, no information was made available to us on the criteria used for identifying the specific selection. Consultants are notified of removal from the list through the normal intracompany communications channels of Merrill Lynch.

We obtained a list from Merrill Lynch Corporation of every focus stock they have placed on their focus stock buy list since implementation of this program on Tuesday February 13, 1990 through December 15, 1998. The final list of firms was compiled from several lists provided by various employees of Merrill Lynch. No one we contacted at corporate headquarters was able to provide the full list. The firms in our sample came from printed lists and not through word of mouth. We are comfortable with the accuracy of the sample data. Whenever possible the date that the firm was removed from the focus stock list also was obtained.

Many of the firms were removed prior to the end of the initial 12-month time horizon. Analysts monitor the focus stock firms regularly; if a firm fails to meet the requirements for being on the list, it is removed early. The only information provided on these early withdrawals is that they no longer meet the requirements. There are at least two explanations for why these stocks are removed early. One reason is that the analysts have received new information and they no longer have the positive expectations that led the stock to be on the list. A second explanation is that the firm performed exceptionally well and has hit the analysts' expected return in a shorter time frame than the initial 12-month horizon.

This research measures the risk-adjusted performance of these stocks on the day they are included on the focus stock list and upon removal from the focus stock list. We also evaluate abnormal returns over the 12-month or less investment horizon covered by the recommendation and its removal.

Methodology

How does the market react to stock recommendations made by one of the world's largest financial services firm? The abnormal returns (ARs) are determined around the date the focus stock selection is announced. When Merrill Lynch places a stock on the focus stock list, we define day 0 as the day following (Wednesday) the Tuesday on which the focus stock is announced to Merrill Lynch brokers. This day is selected because it is the first day in which investors would have knowledge of the selected stock. For withdrawal dates we still consider day 0 as the day after Merrill Lynch officially removes the stock. This date is provided by Merrill Lynch and is called the *pricing date*. The day after the pricing date is used as day 0 because we cannot tell at what time of day Merrill Lynch actually makes the announcement through its routine information procedures. Management may or may not wait until after normal trading hours.

If the information being conveyed by placing a stock on the focus stock list is highly regarded in the financial markets, there should be positive ARs on day 0. If the markets are efficient in absorbing this information, the ARs should be, on average, zero on day +1. Zero ARs also should occur on event days -2 and -1 (assuming no advance trading or leakage of information). We do this recommendation-date analysis for five samples. The first sample includes all firms placed on the list for the first time. We then divide the first sample into two groups. One group consists of the recommended firms that remain on the list for the full one-year horizon. The other group is formed of the firms that Merrill Lynch removes from the list prior to the end of the one-year horizon. Finally, we separately analyze firms that are placed on the focus stock list for the second and the third time.

We will also look at how the market reacts to the removal of the specific stock from the focus stock list. We test the announcement date reaction to the removal of the firm at the end of the 12-month period and also those removed earlier than the 12-month period.

In addition to the announcement date responses, we calculate cumulative abnormal returns (CARs) for the full sample, the one-year holding period subsample, and the early removal subsample. The CARs are determined over the time period from day -1 of the recommendation period through day 0 of the removal period. We include day -1 in accumulating returns because our results show positive abnormal returns on this pre-announcement day. This inclusion permits us to determine whether an investor with pre-announcement knowledge of the selected stock could earn abnormal returns over the holding period. Including day 0 upon removal is consistent with semi-strong market efficiency in that once the removal is made public, the investor would not be able to exploit that information.

An important issue in measuring information response is being able to identify the exact timing of the availability of the information to the investor. This point is not a problem in our study. With the focus stocks we know that the announced buy

recommendation will occur Tuesday evening of each week (excluding the weeks when no recommendation is forthcoming). Womack also accurately identifies the announcement date—he uses *First Call* for his event dates, and *First Call* carries recommendation changes as they occur. No publication delay is experienced. We also have similarities to the Groth *et al.* study in that we are looking at the recommendations of a single brokerage firm and not a group of firms.

The initial sample consists of all 389 focus stock recommendations by Merrill Lynch from February 13, 1990 through December 15, 1998. The 389 observations are less than the number of weeks in the approximately nine-year period. This reduced number results from the fact that Merrill Lynch did not make a focus stock recommendation in 75 weeks.

The standard event-study methodology for obtaining abnormal returns used by Mikkelsen and Partch (1986) and Moore, Peterson, and Peterson (1986), and others will be followed. The estimation period for the market model is the trading days going back 250 trading days starting with event day -2 , usually the Monday preceding the announcement. A pre-event estimation period would seem justifiable due to the unlikelihood of the recommendation disclosing enough new information to change the perceived risk of the firm. The return-generating process is the market model. We use both the CRSP equally weighted and value-weighted returns with dividends as the market index. The with-dividends index is used because the CRSP tape also calculates individual security returns with dividends. Because the results are similar for both indexes, we report the abnormal returns calculated using only the value-weighted index.

Results

The initial reaction to the release of information gives some indication of the value investors assign to the quality of the information. One would expect a positive announcement day response to the release of the focus stock. Table 1 shows the result of the full sample announcement day abnormal returns for the Merrill Lynch focus stocks. When looking at the market response to the announcement of the full sample, the result is a positive abnormal return significant at better than the .01 level on day 0. Day 0 is the first opportunity for the selected firm to be traded by the general public. This result suggests investors believe focus stock recommendations have value.

Of secondary interest in Table 1 is the observation of positive and significant abnormal returns on days -2 and -1 . These two days consist of a time period prior to the public release of the stock's recommendation. The day -2 and -1 price movements could be due to leakage of the information or the purchase of stock by Merrill Lynch insiders prior to the announcement.

Table 1—Event Period Abnormal Returns on Merrill Lynch's Focus Stock Picks, All Firms*

	N	Event Day**				
		−2	−1	0	+1	+2
Full Sample						
Abnormal Return	246	0.0036	0.0061	0.0264	0.0024	0.0006
Significance Level		0.0071	0.0003	0.0001	0.0638	0.6110

* Includes only the first time that a firm is included on the focus stock recommendation list. Merrill Lynch recommended some firms several times over the course of the time period of this study. Most often the repeat recommendation was in the week(s) immediately following the initial listing

** Day 0 is the day after (Wednesday) Merrill Lynch announces their focus stock pick of the week. The announcement is made after the close of the market on Tuesday

No significant abnormal returns occur subsequent to day 0. Hence, in order to earn abnormal returns from the announcement, an investor would need to purchase the security prior to day 0.

We compute cumulative daily abnormal returns for all samples to day +10. These ten-day cumulative returns are significant over the period. Because prices did not revert to pre-announcement levels, this sustained abnormal return indicates that the announcement impact could not be attributed to announcement date price pressures. We did not observe any significant abnormal returns immediately subsequent to day 0; thus, we report results only to day +2.

We repeat the event period tests, dividing the full sample into those firms remaining on the list for the full 12 months and those removed early. The results of this separation are shown in Table 2.

Table 2—Event Period Abnormal Returns on Merrill Lynch's Focus Stock Picks, All Firms*

		Event Day**				
	N	−2	−1	0	+1	+2
Firms Remaining on the List for Full 1-Year Period						
Abnormal Return	85	0.0026	0.0082	0.0185	−0.0013	0.0027
Significance Level		0.2149	0.0023	0.0001	0.6217	0.1465
Firms Removed From the List Before the End of the 1-Year Period						
Abnormal Return	106	0.0065	0.0043	0.0291	0.0028	0.0003
Significance Level		0.0062	0.0808	0.0001	0.1241	0.8767

* Includes only the first time that a firm was included on the focus stock recommendation list. Merrill Lynch recommended some firms several times over the course of the time period of this study. Most often the repeat recommendation was in the week(s) immediately following the initial listing. Of the 246 firms having first time announcements, we had removal dates for 191 firms

** Day 0 is the day after (Wednesday) Merrill Lynch announces their focus stock pick of the week. The announcement is made after the close of the market on Tuesday

For the firms that remain on the list for the one-year period, there are positive abnormal returns on day 0, similar to the full sample response. Day −1 also has a positive abnormal return of .0082 with a significance level of better than 1 percent. For the firms that do not remain on the list for the full year, in addition to the anticipated day 0 significant result and the day −1 abnormal return, we observe a

significant day -2 abnormal return of .0065. We cannot conclude that the early removal firms are driving the day -2 abnormal returns for the full sample because the full sample includes 55 firms for which we do not have removal dates. The information leakage and early-trading explanations also could hold true for this two-day observation for this subset of firms. An additional possibility is that the firms ultimately withdrawn early could have been selected based on momentum performance; thus, abnormal returns are observed prior to public release of new information. This later explanation is in line with the price drift hypothesis offered by Fama, Fisher, Jensen, and Roll's study of stock splits (1969). Why only the withdrawn stocks would present an appearance of momentum is an interesting question and one in which we are currently directing our attention in ongoing research.

Table 3—Event Period Abnormal Returns on Merrill Lynch's Focus Stock Picks, Separated into the Second and Third Time Being Placed on the List*

		Event Day**				
	N	-2	-1	0	+1	+2
Only The Second Time the Firm Appeared on the List						
Abnormal Return	74***	-0.0047	0.0074	0.0185	0.0016	0.0023
Significance Level		0.0733	0.0008	0.0001	0.4880	0.2822
Only Third Time the Firm Appeared on the List						
Abnormal Return	26***	0.0069	0.0079	0.0138	-0.0034	-0.0013
Significance Level		0.0504	0.0177	0.0257	0.3375	0.8352

* Merrill Lynch recommended some firms several times over the course of the time period of this study. Most often the repeat recommendation was in the week(s) immediately following the initial listing

** Day 0 is the day after (Wednesday) Merrill Lynch announces their focus stock pick of the week. The announcement is made after the close of the market on Tuesday

*** Of the 74 stocks recommended a second time 30 were recommended in the week immediately following the first recommendation, 15 were announced at a later date but within one year of the first announcement, and 29 were recommended again after the first one-year period. Of the 26 companies recommended for the third time 10 were recommended in the week immediately following the second recommendation, eight were announced at a later date but within one year of the first announcement, and eight were recommended again after the first and second one-year period

An additional subset of the full sample is justified by the existence of firms that appear on the focus stock list for the second and third times. These firms have been on the list either the immediately prior week(s) or at an earlier date. As shown in Table 3, those stocks appearing for the second or third time generate on average a significant positive response on days -1 and 0. Each recommendation by Merrill Lynch apparently is believed by the investor to carry valuable new information. Even though all three samples have significant day -1 and 0 abnormal returns, the significance of the third recommendation returns is less than under the full sample and the second recommendation sample. This result appears to tell us that, although

still meaningful, the information content of repeat recommendations is less than the first announcement.

Significant announcement day abnormal returns tell us that investors believe that the focus stock recommendation has value. It does not tell us whether these firms outperform a random pick over an extended investment period. To examine this question, we calculate the actual return on the portfolio of stocks consisting of only the focus stock selections.

To obtain the portfolio returns, we calculate the average daily return in event time for all stocks on the list. We remove a stock from the portfolio the day it is removed from the list. The calculation of the portfolio return is shown in the following equation:¹

$$R_p = \sum_{t=0}^T \left[\frac{\sum_{i=1}^I R_{it}}{I} \right]$$

where:

- I = Total number of firms in the portfolio on a particular day in event time;
- T = Total number of trading days over the one-year horizon in event time;
- R_{it} = The daily return on focus stock i on event day t ;
- R_p = The return on the total investor's portfolio if the investor purchased every focus stock and held the stock until it was removed from the focus stock list.

Table 4 reports the cumulative abnormal returns earned by the focus stocks. While the portfolio return of the full sample is 21.90 percent, we find an insignificant abnormal return. Recall that this return includes the positive abnormal return from days -1 and 0 , which allows the total return to be higher than what could actually be obtained by an outside investor.

We take this full sample and disaggregate it into two subsamples. When we look at the first subsample consisting of just those firms that remain on the list for the full 12-month period, we find a significant average abnormal return of approximately 10 percent. Even after removing the recommendation period abnormal returns days -1

¹ To get portfolio returns, we could not calculate a holding period return for each security and take an average return because many of the stocks are held for less than one year. To simply average the holding period returns would cause our results to be biased (in which direction we do not know, although we would hypothesize a downward bias). We chose not to annualize the returns using either compounding or a simple multiple because this approach would assume the ability to reinvest at the same return for the remainder of the year. Given the special selection process and the returns claims of Merrill Lynch for these stocks, such an assumption would be inappropriate and would make our results highly questionable. We thus choose to take the average daily return in event time. The outcome of this approach allows us to determine the returns an investor would earn if they purchased and sold each security in the focus stock list as recommended by Merrill Lynch.

Table 4—Cumulative Returns on Merrill Lynch's Focus Stock Picks Over the Period of the Recommendation *

	N	Average**	ARVW***
Full Sample	246**	0.2190	0.0150
Significance Level			0.4888
Full Year Holding Period	85	0.2669	0.0960
Significance Level			0.0001
Less than Full Year Holding Period	106	0.0834	-0.0215
Significance Level			0.4033

* Merrill Lynch recommended some firms several times over the course of the time period of this study. Most often the repeat recommendation was in the week(s) immediately following the initial listing

** This column is the holding period total return if an investor purchased every recommended focus stock and held the stock over the full range of days that the each firm was on the focus stock recommendation list. Some firms were included for the full one-year holding period, and others were removed early. Both are included in this sample. The firms removed before the one-year holding period are included in the portfolio for the actual number of days held

*** The ARVW is the portfolio holding period abnormal return using the value-weighted index for the time period each firm was on the recommendation list

**** The sum of the firms held for a full year (85) and those held for less than a full year (106) does not equal the 246 firms for the full sample. The difference is due to firms for which we have an announcement date but do not have the removal date. Most of these observations occurred near the end of our sample period when the ending date had not yet occurred. For the 55 firms fitting this description, we assumed a full one-year holding period in doing the return calculations

and 0, we find positive abnormal returns of 7 percent. When we examine the second subsample consisting of just those firms experiencing early removal from the list, we find only an 8.34 percent return. The abnormal returns to those stocks removed early are insignificantly different from zero.

These results suggest that investors will not be able to outperform the market by using focus stock recommendations. At this point in our research, we do not believe that either the portfolio manager or individual investor can ex ante separate those firms that will remain on the list for one year from those that will be removed early. These results continue to support semi-strong market efficiency.

Also of interest is how the market responds when the focus stock is removed from the list, either at the end of the one-year period or on an earlier removal date. The results of this analysis are shown in Table 5. When a firm is removed from the focus stock list, we would expect a negative price response due to the sell recommendation. At the end of the one-year holding period, as shown in Table 5, there are no significant abnormal returns on any of the event period days. Investors appear to anticipate this planned removal and do not find the announcement to contain new information. For the firms removed prior to the one-year termination date, the market perceives this as negative information. A significant negative abnormal return is observed on days -2 and -1. The day -1 result is in line with expectations, as Merrill Lynch could make the announcement during normal trading hours. Again, the significant negative abnormal return on day -2 could be due to information leakage or

Table 5—Abnormal Returns on Merrill Lynch's Focus Stock Picks on the Day They were Removed from the Focus Stock List *

		Event Day**				
	N	-2	-1	0	+1	+2
Firms Remaining on the List for the Full 1 Year Period						
Abnormal Return	85	-0.0010	-0.0026	-0.0040	0.0005	-0.0006
Significance Level		0.6230	0.1756	0.1254	0.7796	0.7469
Firms Removed From the List Before the 1 Year Period						
Abnormal Return	106	-0.0146	-0.0284	-0.0040	0.0017	0.0041
Significance Level		0.0015	0.0001	0.2113	0.4683	0.0997

* When a firm is placed on the focus stock list, the intent is that it should perform well over the next 12-month period. The majority of recommendations remain on the list for the full 12 months. Some firms are removed early from the list because the selection committee decides that the firm no longer meets the criteria for remaining on the list

** Day 0 is the day that Merrill Lynch removed the firm from its focus stock list

advance trading by insiders. Note that we only have removal dates for 191 of the 246 firms in the sample.

Conclusions

The response to the announcement of stocks being placed on the Merrill Lynch focus stock list results in positive significant abnormal returns. Investors appear to view this buy recommendation as favorable information about the future performance of the firm's stock price. We also observe unexpected and unexplained significant abnormal returns immediately prior to the announcement date.

We find that the stocks included in Merrill Lynch's focus stock recommendations do not beat the performance of a market index over the holding period. In order to beat the market, the investor would have to be able to identify ex ante those firms that will not be removed from the focus stock list prior to the end of the 12-month recommended period. Only these firms are able to earn significant positive abnormal returns.

Two unexpected abnormal price responses occur for firms on the focus stock list. For firms included on the list for the first time, we observe a significant abnormal return on day -1, which is the day before the announcement date. For firms that are removed from the list before the end of the normal 12-month performance period, there are unexpected negative abnormal returns on day -2, which again is the day before the announcement date. A potential explanation for these observations is that members of the firm or clients who have been notified in advance are trading on this selection before it is publicly disclosed. Evidence of this type of behavior is not uncommon in the industry, as witnessed by the recent NASD rule approved by the SEC that makes front-running illegal. *Front running* is the practice of trading ahead of research reports on securities. An example of front running is a broker who buys shares in a certain company because he or she knows that his or her research depart-

ment is going to issue a buy on the stock. If this pre-announcement abnormal return is due to leakage and not just spurious, then we must deny the strong-form efficient market hypothesis.

Last, when firms are removed early from the focus stock list, a significant negative abnormal return is observed on the removal date, day -1 . Firms removed from the list after the expiration of the initial 12-month time horizon do not experience any significant announcement date price reaction to the removal. Investors apparently anticipate this removal and perhaps sell the securities over an extended period, thus avoiding any single day selling pressure.

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