Hedge Funds Like Obscure Stocks

Stockholm (HedgeNordic) – A new study finds that hedge funds change their information acquisition and trading behaviour in stocks with reduced sell-side analyst coverage. After reductions of coverage due to closures and mergers of brokerage firms, “hedge funds scale up information acquisition, trade more aggressively, and earn higher abnormal returns on the affected stocks.”

In a paper titled “Sophisticated Investors and Market Efficiency: Evidence from a Natural Experiment,” Yong Chen, Bryan Kelly and Wei Wu examine how hedge funds respond to analyst coverage reductions by adjusting their information acquisition and trading activities, and how these changes, in turn, affect market efficiency. The authors focus on closure and merger-related coverage reductions because such closures and mergers are driven by adverse regulatory changes and unfavourable business conditions in the equity research industry, instead of changes in the prospects of affected stocks.

The study outlines four main findings. First, after reductions of sell-side analyst coverage, stock price efficiency in the affected stocks significantly decreases. Sell-side analysts represent an essential source of information for market participants, which explains why coverage reductions affect security market efficiency.

Second, hedge funds scale up information acquisition after coverage reductions. The authors find that hedge funds increase their participation in the earnings conference calls of the firms with coverage reductions. After examining the internet search traffic for EDGAR filings, the authors find that the search volume of firm names with reduced coverage increases following coverage reductions. More importantly, the surge in search volume is more pronounced from IP addresses that point to hedge funds.

Third, hedge funds trade more aggressively on affected stocks before earnings announcements. “The abnormal hedge fund holdings become larger (smaller) before positive (negative) earnings announcements after coverage reductions, suggesting that hedge funds exploit increased information advantage.” The changes in hedge fund trading behaviour are more pronounced for stocks with an already opaque information environment, and for stocks no longer covered by high-quality analysts. The study also finds that hedge fund profitability from the affected stocks increases after coverage reductions, particularly for purchases.

Fourth, the hedge fund participation mitigates the impairment of market efficiency caused by coverage reductions. All in all, the authors conclude that “when fewer analysts are at work, and the information environment becomes more opaque, sophisticated investors increase their market participation to exploit information advantage.” The authors add that the information acquisition by hedge funds “is negatively related to the amount of information supplied by sell-side analysts, which implies substitution among these information processors.”

The complete version of the study can be downloaded here.

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