

The Role of Financial Analysts in Alleviating Information Asymmetry and Promoting Capital Market Efficiency

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Abstract

Financial analysts reduce information asymmetry and improve the efficiency of capital markets by gathering, analyzing and spreading firm-specific and industry-wide information. Assess the extent to which support from analyst coverage, earnings forecasts, investment recommendations and industry research has enabled external investors to understand complex corporate disclosures better and incorporate firm-specific information into stock prices. Previous research has proposed that the activity of analysts can facilitate price discovery, reduce valuation risk and improve capital allocation under conditions of weak corporate disclosure. Analysts' Information Services are subject to factors such as disclosure quality, corporate governance, analyst independence and conflicts of interest. Optimism bias, herd behavior and investment banking incentives may lead to lower analysis and more market noise. Therefore, the analysts in this study are not passive disseminators of corporate information but active participants in the price-setting mechanism. Tighten regulations on disclosure and safeguard the independence of analysts to improve market information efficiency.

Keywords

Financial analysts, information asymmetry, capital market efficiency, mispricing, earnings forecasts, corporate governance.

1. Introduction

Keep the capital market informed at all times by providing timely and complete information release. Corporate insiders are generally more likely to have obtained material non-public information about the company's business and finances than the general public. When this information asymmetry is pronounced, the market's price-discovery function will be impaired; thus, prices may deviate from the true value, market volatility will rise, and scarce capital will be allocated inefficiently. Therefore, information intermediaries in the capital market, such as financial analysts, have reduced the information asymmetry between corporate insiders and external investors.

The function and effect of financial analysts in the capital market have long been the focus of study. Does the analyst get the information provided by the company passively, or does he also collect other data for himself and the industry independently? The analyst's report can change a company's disclosed information and, thus, alter investors' valuation of the company. With the development of the market and reduced information asymmetry in financial products, more people have been using professional information services.

Analyze the theoretical mechanisms by which financial analysts can reduce information asymmetry and improve capital market efficiency in this paper. At the beginning of the paper, it is proposed that a problem of substantial information asymmetry exists in the market between corporate insiders and external investors. Collect, process and spread company-specific and industry-wide information to help the external market understand the fundamentals of these companies better. Forecasts, recommendations and industry reports

from these sources may also increase the flow of information to stock prices and improve the efficiency of capital allocation.

2. Mechanisms of Mitigating Information Asymmetry

Financial analysts reduce information asymmetry in the following ways: analyst coverage, earnings forecasts, investment recommendations and industry-wide research [1]. The first is analyst coverage; it indicates how often a company is covered by analysts. Research has shown in the past that companies with more analysts covering them have generally received more attention from the market [2]. More analysts covering a company are likely to attract the attention of more investors and thus prompt more frequent and in-depth disclosure by the company. Increased coverage by more analysts may raise the risk of detecting managerial opportunism or selective disclosure [7].

Not only do we need many analysts covering a company, but their research quality and impartiality also matter. Analyst coverage refers to how often a company is covered by analysts and how actively that coverage provides new information. At the same time, they also use other channels to collect data. After some talks, the risk of outside investors being informed about a company's changes in an uneven way has been reduced. More significantly, the various analysts may be interpreting the same data differently, and as a result, the market will give weight to all these interpretations rather than focusing solely on the disclosures released by management. Analyst coverage thus reduces information asymmetry by expanding the quantity and diversity of information. However, this effect will not be achieved unless the analysts carry out research independently of the companies' public disclosures. Therefore, in addition to the accuracy of the forecast, the dispersion of the forecast and any changes in recommendations should also be taken into account. A larger number of analysts can increase transparency; however, if the forecasts are all the same or very inaccurate, then no additional information will be provided for investors [2, 7, 10].

The second is the production and spread of earnings forecasts and investment recommendations [4]. Modern corporate financial statements are generally complicated and technically demanding for the public. Financial analysts collect historical data, speak with the company's management, forecast future cash flows, and thus offer investors more information on the company [2]. Set a particular profit target and issue a "buy", "hold" or "sell" advice to present the company's complicated information in a simple way for investors. Thus, the cognitive burden on external investors is reduced, and the information asymmetry among insiders and the market is also somewhat alleviated [10].

Earnings forecasts and investment recommendations also serve to coordinate the capital market. Forecast accuracy refers to the degree to which a company's future forecast by an analyst is supported by accounting data and other changes in the industry or indices. If the forecast is relatively accurate, the investors' expectations for the company's future cash flow will be more stable, and therefore the valuation risk will be lower. At the same time, many forecasts by analysts have also been released, and these predictions for the future of the company vary from one another. The following are the probable reasons for such dispersion: a relatively high degree of uncertainty; poor disclosure quality; or more complex business fundamentals. Therefore, the spread of analyst forecasts can be used to detect information asymmetry. Investment recommendations also reduce the quantity of analysis required under this information environment by providing a direction. Buy, hold, or sell the ratings to obtain a ready-made assessment of value without extensive research or funds. Therefore, the analysts will also organize the scattered information into a usable form for price setting. Given the above reasons, the firm's value may be harder to judge by external investors due to its complex business model, large-scale intangible assets or lack of voluntary disclosure [1-3, 8].

The third is the production of industry-level and macroeconomic analysis [3]. Analysis does not generally study a single enterprise in isolation but investigates how all changes in the economy will affect the entire supply chain and other enterprises in that chain. A top-down approach can find risks and opportunities in the industry that are not fully shown in the standard financial statements. A high number of analysts will help spread relevant industry information promptly and reduce the risk of a stock price fluctuation due to delayed disclosure by a single company [3, 9]. In conjunction with our own research, a large number of other companies' data will be used to help us better understand how they perform in their own fields.

3. Impact on Capital Market Efficiency

Reduce information asymmetry and improve the overall efficiency of capital markets for financial analysts [1]. Given that outside investors can obtain all-encompassing and in-depth analysis, the risk premium due to information asymmetry will be relatively lower [8]. A lower cost of equity capital may help the firm finance value-enhancing investment projects [6]. Theoretically, it is relatively simple: with a reduction in both internal management and external investor information asymmetry, the capital market will be more information-efficient.

The first change in the market for information is that now prices reflect real economic information more promptly and accurately [4]. According to the theory of efficient markets, the change in this new economic information will be reflected in stock prices almost immediately. At the same time, financial analysts will release forward-looking forecasts and recommendations. Because analysts are competing to release accurate and timely forecasts, these publications will attract a large number of informed institutional investors and boost trading in that area considerably after the announcement [3]. Thus, it can be expected that new information will be reflected in stock prices promptly and market mispricing will be curtailed in both extent and time. When analysts actively cover a stock, the market price will be closer to the actual value of the company's assets, and thus the risk of extended overvaluation or undervaluation is reduced [10].

A relatively low level of market efficiency will be shown by a lack of information and the lack of informativeness in stock prices. In a less transparent market, individual stock prices tend to move in tandem with the whole market or an industry because firm-specific information has not been reflected in the prices to some extent. As more firm-specific data are released by analysts, the stock market will begin to incorporate all kinds of information about the company's internal conditions and other factors simultaneously. Therefore, a lower stock price synchronicity indicates that the prices have accounted for more firm-level information. Therefore, the mispricing will be less enduring. Release related forecasts and recommendations, provide industry data, and help investors adjust stock prices more quickly. Therefore, it will reduce the gap between the market price and the intrinsic value and cause an earlier price correction. It is still possible that the market failure is not covered here; other reasons for price changes may include shifting investor confidence, reduced liquidity and economic downturn. Analysts' work will help reduce the period of mispricing and increase the coordination among public information and stock prices. Therefore, a reduction in information asymmetry can be used to promote the discovery of prices and enhance the efficiency of the market [3, 4, 10].

An optimized price discovery mechanism has also been introduced to improve the efficiency of capital allocation in the economy [5]. A highly efficient market will allocate funds more reasonably to the better-performing companies with good foundations and prospects. Analysts will also be responsible for leading this large-scale flow of funds [6]. Analysts will continuously reveal the company's fundamental deficiencies and expose strengths in the operation of the company to make better use of good economic resources. Based on the above empirical evidence, a sudden, external decrease in the number of analyst coverage reports will directly

lead to a decline in a company's future investment quality and a significant increase in corporate agency problems; therefore, analysts should be employed to enforce strict corporate discipline and promote an efficient market operation [5,7].

4. Boundary Conditions and Constraints

Although the system of theory seeks to enhance market efficiency through financial analysis, there are still some deficiencies in the effectiveness of analysts as information intermediaries. Analysts' effects will not be the same in all circumstances and will be affected by all kinds of factors in that environment. First, the quality of the company's disclosure directly affects the utility of analysts' research [8]. The company has not disclosed this, and there may have been earnings management or other information concealment. The disclosure standards are relatively high, and the level of transparency is also relatively good; therefore, the data for forecasting by analysts are more reliable [1-8].

Second, the structure of internal corporate governance also serves as a general moderator [7]. In a company with weak governance, senior managers may be in possession of important information on changes to the business that cannot be disclosed promptly or accurately to the public for disclosure purposes [10]. Therefore, the analysts may not be able to refute the story told by the company's management or present their own opinions. However, if a good governance system is established that includes an independent audit committee and a large number of institutional investors, then analysts will be more likely to conduct independent research and provide reliable assessments; thus, the research results of analysts will be more likely to promote market efficiency [3, 7].

Finally, conflicts of interest and cognitive biases can reduce the efficiency of information asymmetry mitigation by analysts [2]. Sell-side analysts are often under pressure from large institutional investors to issue overly optimistic recommendations for some companies in order to secure high-paying future investment banking work for their affiliated brokerage firms. A serious structural problem may be the result of excessive optimism and a large-scale spread of herd behaviour; therefore, analysts are unable to conduct independent and in-depth research. If there is a conflict of interest during the course of research, that person will no longer be an unbiased and reliable channel for information dissemination; instead, they may introduce additional noise into the market and thereby worsen mispricing and reduce capital market efficiency [2, 4].

5. Conclusion

As shown in this paper, financial analysts should not be regarded as passive observers of changes in the company; rather, they are active participants in the information environment of modern capital markets. Information asymmetry will cause mispricing and other problems in the market, as a result. Financial analysts collect information from all sides to reduce information asymmetry, then publish research reports, forecasts, investment recommendations, etc. Simplify the company's complicated financial disclosures into very practical and easy-to-understand data, helping outside investors better grasp the company's financial situation.

Therefore, there will be less information asymmetry and greater market efficiency. Prices are more responsive to changes in the economy, the cost of capital may fall, and scarce capital will be allocated to more productive sectors. However, this necessary intermediate link is not completely dependable. Poor disclosure quality, weak corporate governance and institutional conflicts of interest are all possible reasons for this.

In short, based on the above analysis, the value provided by financial analysts will be affected by both the quality of the information they furnish and the institutional environment. Strengthen the disclosure obligations of regulators and market institutions to enhance the efficiency of capital markets, reduce conflicts of interest, and safeguard the independence of analysts' research. Improve the quality and reliability of analyst data to help the capital market better process company-specific information and allocate resources more efficiently.

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