

Summary

‘Comparing Stars – Trading on Star Mutual Funds’ Holdings and Star Analysts’ Recommendations’

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This paper examines the relation between top stock-analyst recommendations and top mutual fund performance. Each year, fund managers elect a small sub-group of analysts to be All-American (“star”) analysts. We find that funds that closely follow these star analysts’ recommendations perform better than other funds. Trading rules that select stocks recommended by top analysts *and* held by top fund managers generate superior alphas than trading rules using either information alone. In contrast, trading rules that follow top-analyst recommendations and the *opposite* of the average fund flow also perform well. These findings suggest that proximity to “stars” and deviation from consensus are both indicative of fund manager skill.

In extensions we show that our findings are robust to rebalancing frequency, the incorporation of a liquidity factor as well as realistic transaction cost adjustments. In particular, net of realistic transaction costs, the four-factor Carhart (1997) and five-factor Pastor and Stambaugh (2003) alphas of a *monthly* trading strategy are around 6-7 percent *per year*.

In summary, our findings suggest that there is a high degree of correlation between top fund manager trades and top analyst recommendations; moreover, improvement can be made by combining the two sources of signals.

Our findings are relevant to recent dramatic changes in the fund management and stock analyst industry. Electronic systems for evaluating analysts' investment recommendations are transforming the relationship between asset managers and stock analysts. "Tops", the most prevalent so-called 'alpha-capture network' system, which was developed by UK hedge fund manager Marshall Wace, tracks performance of analyst recommendations and remunerates analysts based on how this information. To the extent that information on star analyst status is useful, the presence of such networks will put pressure on traditional fund managers that do not have access to these systems.