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STOCK RECOMMENDATION OF AN ANALYST WHO TRADES ON OWN ACCOUNT

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Abstract

This paper analyzes how to provide information acquisition and truthful reporting incentives to a financial analyst who privately trades on own account. The analysis exploits the observation that for a given report, the analyst's reward scheme essentially provides him with a portfolio endowment traded in the market. For every signal, the analyst makes the report that corresponds to the portfolio endowment with maximum market value, given security prices. The principal cannot make the analyst strictly prefer to report the true signal: the analyst is truthful only when indifferent between the two reports. The analyst's information acquisition incentive is driven only by private portfolio considerations: he acquires information only if he will be holding a large enough position in the stock he covers. The paper also presents a general 'separation of the optimal report from private information' result and illustrates that performance based reward schemes can fail to induce any information revelation when the analyst privately trades.

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