In this paper, the authors revisit the negative correlation between earnings forecast dispersion and equity returns documented by Diether, Malloy, and Scherbina (2002). They find that this effect mostly exists only among low credit quality firms and that controlling for the credit quality, it is not statistically significant. This is consistent with the finding that credit risky firms earn a lower equity return as Avramov et al. (2007) have documented. There is therefore a negative risk premium for default risk.

The study uses over 3000 firms from AMEX, NYSE and NASDAQ with data from CRSP, COMPUSTAT, IBES and S&P ratings.

The authors find that earnings dispersion-return relationship is concentrated among firms that represent 5% de total market capitalization but these firms are not necessarily the smallest ones. They confirm the robustness of their results by controlling for systematic common factors, industry effects and firm characteristics (leverage, turnover, idiosyncratic volatility and size). Credit rating takes over earnings dispersion in all their tests.

Across time, they find that the negative correlation between credit risk and equity returns is significant only in periods of rating downgrades. They believe that this reflects the weakening of fundamentals among low-rated companies.

After reading this paper, we have a couple of questions: why is the worsening of fundamentals not priced in the equity? Why do credit ratings have such effect when we know that these measures are often stale and can be dominated by equity-based signals such as EDFs?

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