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Decoding Wall Street's Well-Kept Secrets

As a securities analyst for 32 years, I am amazed that naive investors can be so misled by Wall Street doubletalk. You can be an astute investor only if you fathom the puzzling and often deceptive nature of the Street. Do what Wall Street does, not what it says. Don't take the Street literally. Wall Street operates in strange, ambiguous ways that it would prefer to keep secret. Its research cannot be trusted. The individual investor is an afterthought, mostly neglected by analysts and brokerage research departments. Analysts' opinions change and their statements move stocks. The media passes along analyst commentary and prints their views. Corporate executives react to Street sentiment, and attempt to influence their stock prices. Wall Street cannot be ignored. By decoding the confusing, cryptic Wall Street practices, you can unlock the handcuffs that inhibit superior investing. If you understand the research game to the same degree that professional portfolio managers do, the playing field will be more even.

In mid-1985, I decided to take a new job on Wall Street and make a shift to Merrill Lynch, but I had to sit tight for 10 days. I was scheduled as Louis Rukeyser's guest under the Salomon Brothers moniker and couldn't resign gracefully until off the set of *Wall Street Week*. I

already felt edgy on arrival in the remote horse country of Owings Mills, Maryland. After cooling my heels a couple hours in the studio, Lou, who hadn't finished writing his commentary, wasn't ready to tape the show at the normal time that Friday evening, an hour before it aired on PBS. So my appearance was one of his infrequent programs that went on live—adding pressure and more time to stew. Seated just off the set for the first half of the program with a pitcher of water, I was told to be still or the viewers might see the movement of my shadow. Nervously, I consumed most of the jug and badly needed relief about the time the hostess grabbed my arm to strut me out to the couch in front of the cameras and panelists. My bladder bulged as the hostess whispered to me and we wheeled into camera view, "Don't trip on the platform, three million viewers are watching." I sank down into the gigantic soft sofa, feeling like a midget looking up at Rukeyser, who towered over me in his high-perched chair. All my hours of practiced answers flew out of my head. I was babbling. It was like truth serum, but I survived. Analysts like me are not accustomed to being grilled. We normally have the upper hand. At least we're good at faking aplomb and we rarely come unraveled. This book puts you in Rukeyser's shoes. It's intended to unravel Wall Street security analysts and their research.

What is a Wall Street Securities Analyst?

To comprehend Street research, you must first be familiar with the function of a securities analyst. I am talking about an analyst at a brokerage firm investment bank, not an in-house stock analyst at mutual funds, banks, or investment management firms that cater only to the portfolio managers within their own firm. The job function of brokerage analysts is to conduct research on companies and industries and "sell" it to the brokerage institutional clients and secondarily to individual investors. A typical Street analyst heads a small team of associates, is situated in New York (I was in New York for 20 years and then relocated to San Francisco for the last twelve years of my career), has maybe a dozen years experience, and is in the 30 to 40 age range. The ideal analyst has an MBA degree, should be a Chartered Financial Analyst (CFA), is adept at reading and interpreting financial statements, understanding and building complicated mathematical

earnings models on a computer, writing research reports, talking and interviewing, and selling/marketing. This is a wish list, as rarely do analysts have all these qualifications.

The primary requisite of any analyst is to be an expert on a particular industry sector and group of companies therein. There are analysts covering areas such as high-tech semiconductors or software, retail specialty stores, the oil and gas industry, biotech, airlines, utilities, and banks. I began covering the entire computer industry in the 1970s when it was small, gravitated to focusing on software and computer services in the 1980s, and then covered only computer services starting in the 1990s (companies like EDS, Automatic Data Processing, and Accenture). Analysts conduct research on and rigorously track a limited number of companies in their chosen industry area. They must understand the dynamics, influences, and underpinnings of the industry, and be exceptionally familiar with as much detail on each company as possible—elements like the financials, products, competitive position, management, strategies, and research and development. Analysts must have an ability to judge executives, assess the impact or effect of any number of influences on a company, have the vision to see the big picture amidst tumultuous current pressures on a stock, and analyze a company's outlook with incomplete information in an unclear situation.

It is common for analysts to have worked in the industry they are covering before starting on Wall Street. Analyst industry expertise is more important than a background in securities, investment or finance. I became savvy on the computer industry while employed at the U.S. Department of Commerce tracking the sector there. Wall Street recognized my knowledge of that area and hired me for that reason, not because of my MBA degree.

The next analyst qualification is an understanding of the stock market, investment, and securities (stocks, bonds, options, convertibles, etc.). This is basic stuff, things like listed vs. NASDAQ-traded securities, bid and ask spreads, stock buybacks, dividends, share issuances, stock options, debt (bonds), and all the mechanical aspects of the stock market. Sometimes this is obtained while earning an MBA degree or on the job, in the business, as a junior start-up analyst; and it is enhanced in the process of acquiring the professional CFA designation. I did both, but was further ahead of the game due

to my college summer job at a small brokerage firm in Chicago, reading financial newspapers/magazines and books, investing on my own, and following the market for years before I landed on Wall Street.

Street analysts also need to have some grasp on the economy. My undergraduate degree was in economics. Several economic factors impact stocks and company fundamentals. Analysts should be conversant with elements like interest rates, employment, GDP, inflation, recessions, government spending and borrowing, foreign currencies, and international trade. An MBA degree is a key source to absorb background in economic disciplines.

The securities analyst's role is to determine the industry and individual company outlook in the sector covered, conclude whether the stocks are attractive investments (a Buy opinion) or likely to perform poorly (a Sell), write up these findings in research reports, and monitor all this on a continuing basis. A key mission is to then verbally communicate this research to the brokerage firm's institutional investor clients, and other key audiences like the in-house sales force and traders, and the outside media. Analysts on Wall Street must sell their research, that is, market their product and views. Notice I left out retail individual investors. Analysts don't deal with them directly. To be proficient at this so-called marketing, analysts must be outgoing. No shy types. They make presentations to single portfolio managers or a room full of institutional investors. Analysts have to be convincing on the telephone or over their firm's squawk box. They must have conviction, be strong, opinionated, confident, and come across as cool, intelligent, and balanced, like a 747 airline pilot during a turbulent thunderstorm (my worst nightmare). This requires personality, character, charm, and the need to be colorful and engaging. (Of course, I was all that and more—did I mention humility?)

The brokerage institutional salespeople caters directly to the portfolio managers, traders, and analysts at the firm's institutional clients—mutual funds, hedge funds, pension funds, banks, and other financial institutions. They constantly, all day long, carry the analyst's research message to these institutions, in person, on the phone, or by email. Salesmen may cover a half dozen such institutions and talk with perhaps five or ten key contacts at each one. They also help sell to these big clients initial public offerings (IPOs) and secondary share issuances their firms are underwriting, and set up meetings between

their analysts or corporate executives and these institutional customers. Traders execute sizeable buy and sell orders on behalf of major clients and attempt to make money for the brokerage firm's own account by trading stocks. Investment bankers deal with corporations, governments, and other entities in need of such financial services as selling stock or bonds, doing mergers and acquisitions, and structuring complicated financial/investment transactions.

What's a typical day in the life of an analyst? During the latter portion of my career I was located in San Francisco, where the stock market opens at 6:30 AM, so my hours were on the early side. My firm's morning conference call, where research analysts present pertinent new views or updates, commenced at 4:15 AM. I rolled out of bed at 4:10 AM, tossed on my sweats, and jumped on the horn. As this live broadcast was to hundreds of offices worldwide, it was critical to not fall asleep or screw up. Then, after donning slacks and a sweater, I drove through dark streets, grabbed a giant coffee, cream and sugar, and was at my desk by 6 AM. Things were now happening full blast as it was 9 AM in New York. The sales force was on my case to call key institutional clients to add color to the comments I made on the earlier morning call. My stock screen was racing with price changes, news stories, and other information in my face. Emails by the dozens pleaded for responses, opinions, scheduling, and all sorts of other matters. My team was in the office, wanting to chat or discuss research. No help from my administrative assistant, who waltzed in at about 7:30 AM, and worked fairly normal hours. At some point, I hustled a couple blocks over to a local hotel for a breakfast meeting with a mutual fund portfolio manager.

Back in the office around 9. *The Wall Street Journal* called. An executive from a company I covered was in town and showed up at my door mid-morning. We discussed his firm's business outlook for an hour. My 16-ounce takeout coffee got cold, but I was still sipping it. I had to scrutinize, in advance, a detailed computer earnings model of a company that would report its results at 1 PM this particular day, after the market closed. Soup at my desk for lunch, the first thing I'd eaten all day. The earnings results hit the tape. We did instant analysis, prepared questions, and tuned in on the company's 2 PM investor conference call. It was over at 3, and after a few minutes of pondering and quick analysis, I ground out a research report. Maybe

about 5:30 I waved goodbye to the garage attendants, who gave me no credit since I didn't top a 12-hour day. Alongside me in the front car seat was a portfolio of material to review during the evening with a bowl of ice cream and the baseball game quietly on TV in the background.

Abnormal events in the day of an analyst are normal. I was summoned to a payphone while atop the High Sierras in Yosemite by H. Ross Perot (the other campers were impressed) and was detained by passport control officers at an Italian border crossing the night Aldo Moro was assassinated. I have broadcast my research comments over the squawk box system from aircraft carriers and jumped on the box from phone booths in Vienna cafes. Sometimes I took advantage of the firm's Chicago Cubs Wrigley Field courtesy suite up behind home plate, squeezing in an occasional night game where I had misspent the bulk of my youth in the bleachers. I've witnessed Michael Jordan in the NBA playoffs, gate crashed the Cannes Film Festival, bumped into Queen Elizabeth exiting a London theatre, sipped cocktails at Raffles bar in Singapore, and basked on Waikiki Beach. But there are dodgy scenarios too. Our Kansas City car service driver that I had used for years on client visits there turned up as a fugitive when the police found multiple homicide victims in his home. This mild mannered chauffeur was on the phone with our Chicago sales desk apologizing that he wasn't available for the next assignment, while law enforcement was in pursuit. He was later apprehended, convicted, and given five life sentences.

And then there was September 11th. Jenny Dugan, a junior analyst on my team and I were in New York to conduct a day of one-on-one meetings with investors. Two clients had requested the 8 AM lower Manhattan area time slot, Fred Alger Management and another bigger mutual fund, which ended up getting the nod. Jenny was meeting with the latter client in the World Trade Center tower at 8:50 AM, while I was uptown. The first plane hit one floor below the Fred Alger offices where our meeting would have been were it not for that other request. Tragically, no one at that firm survived. All of us in the business were deeply saddened by the events of that day as we all knew people who lost their lives. Jenny and her group found the stairwell overcrowded and exited via the elevator. To this day she

is reticent to discuss it and has hidden away her WTC-2 security building pass issued that morning revealing her photograph and the September 11th date.

The greatest reward a securities analyst can obtain is being brilliantly correct on a major investment recommendation. I discovered Fiserv as an emerging stock early in the late 1980s, constantly pounded the table with a resounding Buy, and watched it rise steadily in price for more than a decade. A more established company, Computer Sciences, had been a lackluster performer for years when its prospects gradually started to improve. I was the earliest analyst on the Street to recognize the metamorphosis and my favorable opinion shift proved to be an insightful call. It was a winner for years. Conversely, the worst nightmare for an analyst is having a recommendation go wrong. All analysts vividly remember their bad picks.

The perks of an analyst's job aren't bad either. The best place on earth for golf is Augusta National in Georgia, the site of the Masters tournament. Even for Tiger Woods or Jack Nicklaus, that place is sacred. The ghosts of legends like Bobby Jones and Ben Hogan loom down the fairways. So you might imagine the awe that Augusta inspires in a mediocre duffer like myself. When the chairman of an Atlanta-based software firm, John Imlay, part owner of the Falcons NFL football team, inquired of my availability to take in a game from the owner's box, loiter in the locker room, and chat with the coach on the field, I could barely get the yes word out of my stammering lips. And while that was rolling off my tongue, he mentioned as an aside that we'd also be motoring to Augusta afterwards for a couple days of golf there.

Magnolia Drive, the Butler cabin, dining in the clubhouse, each of the 18 holes that I was so familiar with from TV coverage—the entire venue was a dreamy, mystical ecstasy. Caddies handed us the golf club we were supposed to use, not the one we could hit best given our ability—normal people can't hit a two-iron. I maxed out my credit card in the golf shop, was told "those green jackets on that rack are for members only," swiped all the logo-ed stationery out of my room, and feigned a nonchalant demeanor the whole time. My game was atrocious. What do you expect playing on hallowed ground as if in the presence of Divinity? Well, you can see the outing was a highlight in my life, and it wasn't a bad locale to chat up management.

The most trying aspect for security analysts on Wall Street is the insecure feeling of always being vulnerable to anything that might impact the stocks they cover. The fear stems from realizing that at anytime during a business day a company under coverage might announce dramatic surprising news. An analyst in this circumstance must scramble, jump on a conference call, respond to an avalanche of inquiries from the sales force and investors, and instantly assess the situation to form an accurate view. This is difficult enough if the analyst is in the office with all necessary resources at hand. It's a disaster if it happens during a tightly packed all-day client meeting trip, while on an airline flight, vacationing on a cruise ship, or on the golf course. Analysts can never relax on days the stock market is open. Even on holiday in August we monitor our Blackberries and call in periodically every business day, just like a doctor on call.

Heavy travel is inherent in the investment analyst profession. Travel stories are legend. Seated in the last row on a flight from Seattle, I could see before take-off that the emergency exit door behind me was left ajar. Daylight was peering through the opening. Upon pointedly notifying the attendant, she phoned the flight deck but, without inspecting it, the pilots pronounced the hatch secure from the cockpit because there was no indicator light on. My seatbelt was strapped on like a tourniquet. I knew the outcome—we wouldn't be airborne long without pressurization—and was flabbergasted by the crew's attitude. One circle of the airport, and we were landing again. Bulky maintenance brutes tried slamming the hatch to force it tight. They were still banging away when I grabbed my carry-on baggage and bailed, my confidence shot. Several others followed. So much for aircraft structural integrity.

Twice I've been on a plane that was struck by lightning, a bright flash outside the window and a thunderous boom. Good for the nerves. I knew a fellow analyst at a different firm who was on the Pan Am 103 Lockerbie flight, blown out of the air by a terrorist bomb. Several of us attended the funeral. A little macabre, but with such extensive travel, analysts are exposed to risks. An associate's flight from New York to San Francisco hit sudden turbulence, plummeted 10,000 feet, the service cart and attendants hit the ceiling, red was splattered all over the floor thought to be blood but later found to be red wine, and the plane made an emergency landing in Kansas City.

After realizing the function and role of Wall Street investment analysts, you need the rest of the story. That's what this book is all about—the reality and well-kept secrets of Street research. To be effective, investors need to comprehend how Wall Street operates, to work around it in some cases, and to take advantage of it in other situations. You will be able to invest on a par with the professionals once the strange, deceptive ways of Wall Street are demystified.

Wall Street Analysts Are Bad at Stock Picking

It's a shocking truth, but the way the system is oriented, stock picking is not the analyst's job. Until recently, brokerage firms did not even track the accuracy of their analyst opinions. The skill was neglected for a long time. It was just not an important part of the analyst job description. Wall Street analysts are supposed to pursue information about the companies and industries they cover, evaluate and gain insight on the future prospect of those companies, assess their investment value, and form opinions on the outlook for their stocks. We are required to assign investment ratings such as "Buy" or "Sell" to indicate a net overall evaluation. And that's where the real issues start to surface. Professional qualifications, incentive compensation, and the main audience—*institutional* investors—do not stress this function of stock picking at all. An *Institutional Investor* magazine survey in the fall of 2006 asked the buyside institutions—mutual funds, banks, pension funds, and hedge funds that buy and sell stocks through the brokerage firms—to indicate the most important attributes they sought in sell-side (brokerage) Street analysts. Of 12 factors ranked in order of priority, stock selection placed 11th. Obviously, this skill is not an analyst job function required by their foremost audience. As a result, stock picking is neglected.

For years, the *Wall Street Journal* published a quarterly dartboard contest. The expert stock selections by analysts and portfolio managers did no better than those picked randomly. In another test, a website featuring a newsletter called the "Paradox Investor" assessed the performance of all Sell- and Hold-rated stocks on the Street for a two-year period ending in the fall of 2003. This portfolio of negatively

viewed stocks gained 53.5%, more than 75 percentage points better than the market. When stocks have several Sell recommendations, there is nowhere else for that stock to go but up. Once the fourth or fifth Sell opinion is issued on a stock, it is probably ready to recover. Analysts are usually late and are also copycats. Mutual fund money managers are no great shakes either. Barron's conducts a poll every six months. In spring 2006, the professionals' Sell recommendations from the year before had surged ahead by 28% compared to their Buys that climbed just 13%. And in spring 2007, these pros' picks from the prior year actually dropped 2% but their pans were up 6%. Daunting.

If that's not enough proof, Charles Schwab rates stocks A to F. From May 2002 through Oct. 2003, its F-rated names, those deemed to have the poorest prospects, performed the best of any category, ahead 30%. In another survey, the *Wall Street Journal* reported that Investars.com ranked Street research firms by how each one's stock picks performed compared to the S&P 500 over a one-year span ending in May of 2005. You've probably never heard of four of the top five: Weiss Ratings, Columbine Capital, Ford Equity Research, and Channel Trend. The major brokerage Buy-rated stock results were strewn further down the list. Pretty much the same pattern held true when evaluated over a four-year term. The Street pushes analysts to emphasize institutional handholding and marketing, not research and stock recommendations. No wonder the record stinks.

Insightful research analysis has little bearing on the accuracy of Buy or Sell recommendations. Brokerage analysts are usually good at providing thorough, informative company and industry research. But their investment rating track record is mediocre, and in many cases inverse to their compensation. The system spawns this fatal flaw because analysts are being compensated mainly for profile, status, clout, and industry/company knowledge rather than for investment opinion accuracy. The extreme influence and impact of analysts can result in great damage when investors are misled. Jack Grubman is the poster boy example here. As a telecommunications analyst with more experience compared to most of the green Internet analysts, he should have known better. Apparently not, as is evident in his *BusinessWeek* quote about his overt, subjective cheerleading of the stocks of investment banking clients he dealt with: "What used to be

conflict is now a synergy." He shunned his fiduciary duty to be relatively unbiased as an analyst. Grubman's incestuous investment banking behavior destroyed his research credibility. Several of his top recommendations were advocated almost all the way into Chapter 11—Global Crossing, MCI Worldcom, and others. He's now permanently barred from the business.

Analyst compensation, often more than one million dollars annually, is unrelated to the performance of their stock recommendations. A portfolio manager's investment record can be tracked daily in the mutual fund listings. But analysts are not paid for the accuracy of their stock opinions. Their income depends on institutional client polls, overall eminence and influence, institutional sales and trading evaluations, aid in doing investment banking deals (there is still involvement here), and overall subjective judgment by research management.

Opinion Rating Systems Are Misleading

Even if the Street's investment opinions were credible, investors still couldn't determine exactly the meaning of the recommendation. Sometimes Buy means Sell. Brokerage firms have differing stock-rating terminology that can be highly deceptive. Analysts are often forced to hedge, as their investment opinions attempt to straddle dissimilar audiences. Although most firms have contracted their stock opinion format from four or five different gradations to three, there is still excessive wiggle room for hedging. The famous Neutral or Hold monikers are merely a way for analysts to hide and save face, since after the fact they can usually argue that they were accurate, however convoluted the claim. Investors have no clue what to do with such a Hold opinion. Only the highest rating in any firm's nomenclature, usually Buy, Strong Buy, Overweight, and so on, indicates that the analyst has a favorable view on a stock. Or does it?

In the latter part of 2006, according to Barron's, a Morgan Stanley analyst initiated coverage of Toll Brothers with an Overweight rating, the stock trading above $29. Sounds positive, doesn't it? Well, the price target was $23, indicating his expectation of a major drop in price. Apparently, that firm's rating meant only that the stock would do better than its counterparts in the home building industry. This is

no help to investors who might have believed the opinion called for a bigger position than the norm, and who could lose that much more money. Confusion reigns.

Analysts use lower-level ratings, such as Accumulate, Above Average, Hold, Neutral, and sometimes even Buy (if the firm has a superior Strong Buy in its system), to convey a negative stance to their key client base, institutional investors. They avoid the more pessimistic classification levels like Below Average, Underweight, Under Perform, or Sell. In order to dodge the flack from corporate executives and those institutional investors who own big positions in the stock. It is also a way to massage investment bankers. Accumulate opinions were once referred to euphemistically as a *Banker's Buy*. Sounds positive, but in reality it's negative. It helps the analyst save face.

When an Opinion Is Lowered from the Peak Rating It Means "Sell"

Any stock rating below the highest level connotes an analyst's pessimism or cautious stance. An analyst opinion change from the top level is tantamount to a literal Sell recommendation. Maintaining the top long-term classification while reducing the near- or medium-term view is another decisive communication of a gloomier opinion. And one should totally disregard all "long-term" ratings. They represent another analyst dodge.

The current almost universal three-level investment rating scheme is fraught with confusion and disparities among different firms. The *Wall Street Journal* asked, in an article discussing a National Association of Securities Dealers (NASD) study, how ratings were applied. "Is an *underperform* stock in an *outperform* industry more attractive than an *outperform* stock in an *underperform* industry?" For sure, the jargon defining investment terms needs to be clearer and more consistent throughout the Street. Does Overweight mean Buy? Recommendations can be absolute or relative. Analysts can cite accuracy with a positive opinion if it outperforms an index or the market, even if the stock declines and investors lose money. An absolute term like Buy might portray an indication the stock may rise anywhere from 10% to 25% in the next 12 months. According to the

Journal article, at Bear Stearns Outperform implies the stock will do better than the analyst's industry coverage. At Smith Barney, a Buy connotes an expected total return of more than 15%. A Buy at UBS Warburg says it's supposed to rise 15% or more over prevailing interest rates. Thankfully, some firms have finally gone to just one investment rating timeframe, eliminating the near-term and long-term tandem that was often a conundrum. But there's a long way to go to get the industry's investment rating systems on a similar page.

It's impossible to determine the level of an analyst's enthusiasm or skepticism from the published rating. Recommendations vary in degree of fervor. Sometimes a Buy is a rather wimpy, weak, low-key endorsement. Other times, a Buy might be a table pounding, jump out of your shoes, immediate action indication. A Hold can be fairly positive, say when the analyst is in the process of gravitating toward a more favorable stance, prior to an upgrade to Buy. Or a Hold could mean the analyst thinks the company's outlook and stock prospects are terrible, but he hesitates to upset vested interests with the dreaded Sell word. The latter is usually the case. The Street normally interprets Hold opinions negatively and so should the individual investor.

Wall Street investment advice is further blemished by being risk adverse. Opinions on stocks are hedged. This obviating is pervasive, stemming from disparate audiences and a mortal fear of being wrong. Sometimes analysts have a Neutral short-term view (this means negative) but a slightly more positive Accumulate or Above Average long-term opinion. That translates into a terrifically negative view, but it's equivocal. If it's a simpler system, the analyst may carry only the Neutral recommendation. That way, he can dodge responsibility no matter how the shares perform. If the stock spirals lower, you'll hear, "I wasn't really recommending it." Conversely, if the shares climb, there'll be nothing but silence. Even Strong Buy ratings carry different degrees of enthusiasm. If the analyst has six or eight companies with the same optimistic opinion, there will be credit taken for those stocks that ascend. A ready excuse is offered, that the name wasn't among the top two or three best picks, for any of those whose prices meander.

The ideal rating system would be a two-pronged scheme to push analysts into one camp or the other. This could be positive/negative,

outperform/underperform, or overweight/underweight. Notice my terms for bad stock prospects are less harsh than Sell but indicate essentially the same thing. They aid the analyst and brokerage firm in saving face, and in pacifying relationships with institutional holders and corporate executives. Forget using Buy/Sell—too crass, politically unacceptable. By setting up such a simple system, the analyst view on the stock would be more clearly communicated, and the accuracy more readily tracked. No hedging, no equivocating. But don't expect this to ever happen. Wall Street is not that accountable.

Going a step further, and removing investment ratings altogether, may be advisable for the sophisticated institutional audience. Portfolio managers and buyside (institutional investors) analysts draw their own conclusions and make their own investment decisions. Sellside (brokerage) analyst stock opinions are an annoyance to these investors. Analysts can deliver the same value-added investment research to institutions without this distraction. Research quality and objectivity would improve if analysts no longer felt the pressure of incurring the wrath of big holders and corporate executives when lowering an opinion.

Street investment opinions are also tarnished in other respects. Wall Street loves stocks that are rising now. There is no patience to wait for future upside. It is difficult for an analyst to upgrade a depressed, languishing stock even though it may have a value. It could take too long to move. Once a stock has appreciated and "looks good on the chart," it is much easier for analysts to get all the necessary committee approvals. Such a recommendation is more readily accepted by institutional clients, and there is less risk for the analyst.

As a result, upgrades are usually late, missing much of the rise in the stock. Boosting an opinion requires clear catalysts, evidence, and precise forecasts, all difficult to spell out early. Thus, Buys are rarely value oriented. They are momentum driven. Committees that oversee recommended lists refuse stock suggestions when the price is bumping along the bottom and shows no upside momentum. As a washed-out value, it runs counter to the mentality of the committee. Investors can outwit the Street by seeking stocks that are not in favor or being widely recommended, represent value, and may eventually attract opinion upgrades.

Research Reports Do Not Contain an Analyst's Complete Viewpoint

Because reports are in the public domain and are read by all the disparate audiences that analysts confront, particularly negative or controversial content is watered down, or modulated. The degree of our skepticism, aspects of a company that are unclear but highly suspect, untrustworthy management, lack of confidence in estimates, anything edgy, doubtful, any wariness—none of this gets put into writing. If it did, legal compliance would edit it out anyway. Reports get such scrutiny that analysts are careful; they hold back and reserve the touchier, conjectural content for direct conversations when they can tailor it to a specific institutional client. An analyst's body language or subtle leaning on a stock are never revealed in writing. Although analysts are no longer legally able to hold a radically conflicting stance than the one portrayed in the report, there is much left to be read between the lines.

The Entire Stock Market Is Biased in Favor of Buy Ratings

Think of Wall Street as if it were the auto industry. Automobile companies make cars and trucks. Through their dealers, they sell these products aggressively. Given their vested interest, auto dealers recommend "buy." You've never heard them tell consumers to "sell." An article by Clifford S. Asness in the *Financial Analyst Journal* makes this comparison. He accurately states that, "A large part of Wall Street's business is selling new and used stocks and bonds, which strangely they do make recommendations about." Of course, the Street rarely espouses bearish views on the very products it wants to sell to clients.

Wall Street is totally oriented to a rising market and upward moving stock prices. The common terms used by the Street to describe stock market conditions are heavily slanted toward the positive. When the stock market drops and you lose money in your stock holdings, it's called a "correction." Isn't that absurd? "Volatility" is another term that often surfaces to describe a falling market. Isn't a surging market just as volatile as a declining one? A plummeting market

finally bottoms out, and it's seen as "stabilizing," a favorable description. But if stocks are soaring, the market is never portrayed as being unstable. The Street just keeps trying to sugarcoat or neutralize the situation when stocks are not climbing in price.

Institutional investors hold stocks, are long, and rarely sell short or bet on a decline. Most mutual funds and institutions are not allowed to short stocks. Analysts are incentivized to issue Buy opinions by the favorable feedback that flows from major institutional owners of the stocks and from corporate executives. Analysts are discouraged from negative views by the adverse reaction from these constituencies. Sell opinions, especially if in the minority, put us on an unpleasant hot seat.

A *Wall Street Journal* study in early 2004 found the positive bias to be most glaring at smaller brokerage firms that still seem to be in the rut of hyping a lot of Buy recommendations. Even the ten major firms that agreed to several research reforms in a 2003 industry settlement with the New York Attorney General, averaged about twice as many Buy ratings compared to Sells. The ratio was almost seven times more Buys at smaller firms. In a mid-2006 CFA magazine article by Mike Mayo, it was noted that of the recommendations on the ten biggest market cap stocks in the U.S. there were 193 Buys and only six Sells. Systemic bias? I'd say there are vast brokerage investment banking opportunities with these major corporations, subtly swaying analyst opinions. The system is stacked against negative recommendations.

Analysts have an anthropomorphic tendency to fall in love with the companies and stocks that they are advocating. It's like identifying with your captors. Human instinct. The bias is ineffaceable. Some of the insanity has been eliminated and subservience to investment banking is reduced. But don't think for a second that full objectivity has been restored. The percentage of favorable Street recommendations still far outweighs negative opinions, at least if you take published ratings literally. In early 2001, ten months into the precipitous market slide that followed the bubble, Salomon Smith Barney had only one Underperform and no Sells among nearly 1200 stocks it was covering. According to Zacks Investment Research, of the 4,500 stocks it tracked in the fourth quarter of 2005, 42% were rated Buy or Strong Buy. Only 3% carried Sell or Strong Sell recommendations. A

research report by a major Street firm in spring 2007 indicated its research department investment rating distribution was 45% Buys, 47% Neutrals, and 8% Sells.

A study by UCLA, UC Davis, and the University of Michigan reveals another form of skewed recommendations. Independent stock research opinions are more accurate than analysts from brokerage firm investment banks. The record was about equal during bull markets when Buy ratings are prevalent. But independents stand out in bad markets when they promulgate more negative views. Brokerage firms are seemingly reticent to downgrade investment banking clients. Gee, why am I not surprised? A brokerage analyst invariably maintains a closer relationship and has more access to executives of an ongoing banking client, creating another positive bias. Studies prove that the analyst at the brokerage that leads an initial public offering of a company, provides noticeably more affirmative coverage than analysts at firms unaffiliated with the deal.

Buy and Sell Opinions Are Usually Overstated

Analysts cheerlead their Buys, and disparage the Sells. The Street tends to overdo its enthusiasm on stocks being strongly recommended, effectively pounding the table to attract investors to amass major positions. The ardor is self-fulfilling. The more proficient analysts are in this endeavor, the higher the stock climbs, and the better our call looks. We promote these favored ideas way out of proportion to the reality, and the stocks can ascend to artificially high, unsustainable levels. The opposite is true for the infrequent Sell opinions. We are overly emphatic on all the negatives, diss the company at every opportunity, and basically pile on an already troubled, depressed stock. This is to help push the shares lower to make our negative view all the more correct. In both situations, analysts overstay their positions. Stocks overreact in both directions far beyond what is warranted by reality, due mainly to analysts going overboard in stressing their stances. Investors should sell when analysts get overly enthusiastic and avoid unloading (maybe even buy) when an analyst has derided a company too long.

Wall Street Has a Big Company Bias

Another bias on Wall Street is an ongoing emphasis on big companies. Analysts have a tendency to focus their coverage on stocks that have the highest market capitalizations. These names are more actively traded and widely held, with the most institutional investor interest. This is where most investment banking business is derived and investment firms generate most of their equity business profits. The bulk of phone calls and press attention pertains to such companies. They are over-covered, over-analyzed, and the price valuations of their stocks tend to be more efficient, fully reflecting all known factors. Technology, telecommunications, and healthcare are the most over-researched, covered by the most analysts. Wall Street tends to add analysts in sectors where it does the most banking and trading business, not necessarily in areas representing the best investments. According to a study by Doukas, Kim and Pantzalis referenced in CFA Digest in mid-2006, there is a clear relationship between excess analyst coverage and stock premiums. The same study showed a direct correlation between low analyst coverage levels and stock price discounts.

Individuals can benefit by making an astute, early investment in smaller companies not already picked over by Wall Street. Mutual funds and other institutions need to take sizeable positions in stocks. Though they may invest in some smaller cap stocks, even a spectacular winner there has minimal influence on a fund's total performance. Therefore, when analysts pound the table on a thinly traded company that proves to be a fine idea, the overall impact is muted. There are meager economics for a brokerage firm in recommending small stocks, whether for trading, banking, or commissions. Brokerage revenues are decidedly boosted by outstanding calls (a rare event) on broadly held stocks, not small caps.

Executives and board members have a similar preference for bigness—they hesitate to do spin-offs, love acquisitions, and are obsessed with company size, enjoying the status of being a part of the S&P 500. But mass usually indicates mediocrity. And mega-mergers never work. Smaller market caps are not emphasized by analysts. Even if a small cap stock is a table pounding Buy recommendation that soars in price, the analyst gets little recognition for being an

advocate. Small companies have few shares outstanding and thus only a scant number of investors own the stock and benefit from its appreciation. Most analysts at major firms get attention and make their reputations by emphasizing big cap recommendations. Small stocks present the individual investor with a better prospect of undiscovered value and the potential to achieve greater prominence in the future as their market caps expand.

Brokerage Emphasis Lists Are Frivolous

Most brokerage firms sport their top stock picks in a high-profile emphasis list. These featured rankings are amateur hour. While they often flaunt a statistical case that such Buy collections outperform the market, these "best" recommendations do not perform materially better than all the other favorably rated stocks lacking such exalted status at that firm. Such comparisons are glaringly absent in brokerage research because they are too embarrassing. *Barron's* quantifies the brokers' model portfolio performance every six months using Zacks Investment Research statistics. The record isn't pretty. In 2006, the average brokerage recommended list underperformed the S&P 500. The leader was Matrix USA, not exactly one of the biggest firms on the Street. Over a five-year period, they lagged again, ahead only 44% on average compared to the S&P 500 equal-weighted total return of 69%. The five-year winner was a firm that has no in-house fundamental research analysts—Charles Schwab! What does that tell you?

Like a zephyr, emphasis list ideas blow in and out. Selection committees can be a charade. If they need a new name to add to the exclusive list of best recommendations, the technical chartist might suggest those Buys that have good charts. Analysts in the firm are called and possibilities are trial ballooned. Their decisions are often surprising. The most perplexing aspect is the rather frivolous manner by which these lists are maintained. Assuming a one-year investment time horizon, panic and anxiety can strike these committees when a stock moves a few points. Hip-shooting is common; emotions and stock price charts rule the day. There seems to be no consistent, longer-term, investment-oriented approach. An analyst's best recommendation can be yanked despite protest after falling a few points. Even if it recovers, the name is long gone from the list.

Stock Price Targets Are Specious

Analysts are now required to have price targets on research reports, with attendant justification, which can involve a formal model to calculate fair or intrinsic value. But this also means predicting the future, encompassing influences like overall stock market trends, the economy, war, and interest rates, which are far beyond the analysts' presumably good insight into company and industry prospects. In the bubble years, the Internet analysts pulled absurd, astronomical triple-digit price objectives out of the blue, and naive investors actually gave these goals credence. It still happens, as in the case of the excessive expectations for the Google stock price. In current, more rational times, the guesses may be a bit more tempered but are still unrealistic, or at least unbalanced. Stock price estimates are utilized to emphasize Buy or Sell ratings. Analysts put too high a goal on stocks where they have favorable opinions to help justify their view, and to assist in marketing to hype the story. The price point forecast is artificially low for companies on which analysts are negative. Another issue here is that when such a target is hit, it can trigger a downgrade in analyst opinion. That impacts the stock price and is an adverse short-term influence on long-term investors. Opinion changes based on the stock achieving a published price target should be taken lightly. You can see what I think of price objectives—terrific if you like fiction.

The Street Is Extremely Short-Term in Its Orientation

The modern era of research transformed security analysis and investing, all of Wall Street really, to a shorter, briefer length for everything. Investors can exploit this tendency and enhance portfolio performance by being longer-term oriented, and more patient and value focused. Institutions are entrapped by a quarterly treadmill of performance evaluation. Their investment time horizon has shrunk drastically. If any stock recommendation lacks upside potential in the current quarter, a professional portfolio manager's eyes glaze over. Analysts have succumbed to this same frenzy of near-term expectations and demands. Attention spans are telescoped, so research

reports are shriveled in size. Corporations are subsumed by the same trend. Quarterly earnings results are the paramount milestone, a critical influence, the subject of intense analyst emphasis. Annual earnings estimates are dwarfed by expectations for the existing quarter. And it is this short sightedness that gives the individual investor an opening. An individual can really invest and hold stocks for at least two or three years to improve performance results, because they are not being judged on a quarterly basis like the Street.

Wall Street analysts are supposed to be investment analysts doing investment research. That means their conclusions, findings, views, and recommendations are to be investment oriented, having a time horizon of at least a year or two. Yet most institutional clients, particularly the biggest commission producers like hedge funds, are short-term trading oriented. The same for key intermediaries, institutional sales, and the brokerage firms' trading desks that analysts deal with constantly. Mutual fund performance is tracked daily and is measured against the competitors every quarter. Analysts are torn between two conflicting goals. Earnings estimates, price targets, and other prognostications on the companies that analysts cover extend a year or more into the future. But intense pressures mount from clients, traders, and research management for a recommendation to prove out in a period of just days or weeks, months at the longest. This causes Street research to be focused myopically on immediate influences. Analysts are catering to a market of traders rather than a market of investors, and so what they undertake is really trading research. Most Street research is unsuitable for the true, long-term investor.

Research reports and brokerage stock rating systems indicate a one-year investment timeframe. In reality, opinions are based on analyst thinking of how the stock may do over the next one to five months, at the maximum. This stems from the exceedingly short-term trading mentality on Wall Street. If analysts do not believe the stock will take off within the next couple months, there will be no opinion upgrade. The key institutional investor audience seeks instant gratification and is impatient, like the rest of Wall Street. A question I constantly heard was: "What is the catalyst that will move the stock?" When raising an opinion, the Street always stresses the immediate expected development that will drive the price higher. Don't ever

think any recommendation is based on how the stock will perform over the next year or two. We get hounded or criticized if our stock recommendation stagnates for even two or three months. Wall Street is not focused on the long-term. Patient investors can outmaneuver Street insiders by a willingness to buy early and hold for a couple years and not be whipsawed by temporary influences.

The short timeframe that defines Wall Street necessitates speed. Analysts are compelled to stress quickness over quality or thoughtfulness. Immediate interpretation of news or events is demanded. Once put forth, the inclination is to stick with that stance, even if later evidence or assessment indicates a different conclusion. Erroneous instant reactions have a way of manifesting over time. Research reports contain mostly reported facts rather than unique, original analysis and inferences. Analysts also love PC-generated earnings models and gravitate toward quantitative aspects. Far more telling is the esoteric, qualitative side to a company's business that is more difficult to evaluate. Such quality security analysis is scant since it takes too long, and analysts are normally in a reactive, hurry up mode.

Analysts Miss Titanic Secular Shifts

This is another consequence of a short-term viewpoint and the herd instinct. Broad industry themes last a while. Major movements like a new technology, a different manufacturing process, or consumer habits that are catalysts for a sweeping industry move are readily identified by the Street once in place and obvious. The trend is underscored as the key underpinning of ongoing recommendations. The problem is that Wall Street always espouses the view that this overwhelming industry effect will endure for the foreseeable future. Inevitably, a critical turning point is eventually reached when the trend begins to subside. But it's subtle. And because analysts are momentum oriented, they rarely see the shift until it's way late. They are too narrowly concentrated on details and do not heed the bigger picture. Analysts are so consumed with marketing, telephone calls, meetings, conference calls, publishing short blurbs, traveling, reacting, and scrambling that there is no time for studied, overall macro-assessment. They may be good at evaluating the trees, but they fail to have enough vision to see the forest.

Analysts rarely take seriously the emerging companies that are pioneering a new wave. They are similar to executives who play a defensive game to protect their turf. Established companies rarely create new technologies that make their existing entrenched products obsolete. Analysts also become fixed in their coverage and views, and are predisposed to defend a favorable ongoing opinion of a recognized industry leader. Like the ostrich, they fail to give proper credence to up and coming companies that represent a disruptive market leapfrog. Analysts are uncomfortable with any thinking that might run counter to their long-established point of view. Because the status quo is easier, they often miss the boat when a new force emerges.

The rise of PC software in the late 1980s brought a surge of IPOs, including Microsoft, Lotus Development, and Borland. A friend of mine since elementary school, then an orthopedic surgeon in Ohio, inquired naively whether he should pick up a few Microsoft shares once it started trading. I thought it and a myriad of others—each specializing in spreadsheet, database, operating system, and other PC software—were a speculative flurry and a risky proposition that investors should avoid. Bill Gates' company seemed just like the rest of the bunch, and not that special. And these new companies were challenging the entrenched, established software for larger computers. So I dissuaded my school chum. He could have retired earlier were it not for my foolish advice. I paid only passing attention to this new PC software age. My counterpart at Goldman Sachs, Rick Sherlund, did the Microsoft initial public offering (IPO) and was the early axe in that stock—that is, the most informed analyst covering the name. Within a few years, Microsoft vaulted to the most important and thriving firm of all software and computer services. Sherlund then displaced me as #1 in the vaunted *Institutional Investor* rankings. I paid the price for my oversight.

Street Research Unoriginal, Opinions Similar

Not only is the Street myopic, it is also unoriginal. Everything the Street now publishes or communicates is excruciatingly reviewed for approval. Although research may now be more credible, it is hamstrung,

emasculated, and diluted. Pithy, original, or controversial content is difficult to communicate to investors. Analysts run in packs and find standing alone to be uncomfortable. The Street tends to have similar opinions on most stocks. Analysts identify and underscore the macro industry trends in the stock groups covered, which puts them all in the same boat. If the sector is in favor, almost all of us recommend just about every stock. We love a stock when fundamentals are healthy, regardless of excessive valuation. The same is true of the negative side. After major disappointments or shortfalls, we all belatedly change over to negative views. There is little uniqueness or willingness to stand alone from the pack.

Further diminishing the relevance of brokerage investment research and opinion ratings is that research reaches individual investors late. Analyst contact priorities are the sales force and traders, then the press. Stocks react when events occur and news breaks. The analyst first jumps on the squawk box and makes comments to the sales force. Traders get a call about the same time. (They're not supposed to be first, but sometimes they are.) After returning phone calls from institutional sales, the next priority is the press. We love to see our remarks running across the Dow Jones newswire—and Bloomberg, Reuters, and the next day's *New York Times*, too. Then we might start chatting with the key institutional clients like Fidelity. By the time most investors hear of or read our research views, it is way late. Its tardiness renders it worthless for near-term trading. Individual investors are low in the analyst's pecking order and need to treat Street research accordingly.

Analyst Research Is Valuable for Background Understanding

Street security analysts are good for something; they publish expert company and industry research, which is useful for gaining a thorough understanding of the business fundamentals. Research reports detail numerous aspects of a company that provide good background for an investor. Areas such as the earnings outlook, profit forecasts and earning models, business operations, the market, competition, issues and challenges, management, and finances can be readily comprehended

by utilizing the reports of research analysts. Such analysts are highly knowledgeable on the industries they cover, and if they have tracked a particular company for a few years, their expertise is deep. Analysts attend briefings for company investors, participate in management conference calls with the Street, and periodically talk with certain executives, such as the chief financial officer (CFO) and director of investor relations (IR). On conference calls, available to all investors to listen in on, analysts ask probing questions, flush out the real story, and are good at exposing critical elements. Because analysts have active contact with executives, they are completely familiar with the company party line, the company's goals and objectives, and its management style. Individual investors are rarely directly privy to this type of information, but this color finds its way into research reports.

Analysts, given their usually steep company and industry expertise, are good at identifying events and influences that could have an impact on a company's outlook. When news breaks or an event occurs, Street analysts can provide detached, cool-headed, informative commentary as to the fundamental effect it might have on a company. This is a common occurrence. A leading competitor in an industry sector has a negative earnings or order rate shortfall. A big acquisition is announced. A blockbuster new product development comes to light. A hurricane or other natural disaster takes place. All these types of news can affect the stock prices of a number of companies. Analysts normally issue reports that shed light and provide an explanation in such circumstances. Often this research is rushed, tends to be a short-term interpretation, and can always be wrong, but it is useful for getting the gist of the situation.

Earnings estimates are another valuable tool contributed by analysts. These are normally accompanied by comprehensive earnings models that indicate forecasts of revenue, operating profit margins, tax rate, cash flow, return on equity ratios, and other such quantitative measures. Earnings projections are both quarterly and annual, and are helpful in assessing the stock price valuation based on the price-to-earnings (PE) ratio. The anticipated rate of growth in profits is an important element in the overall outlook for a company. But the best use of these numbers is in comparing actual results. Stock prices react each quarter to the slightest shortfall or overachievement in results. And they can move precipitously in response to modifications

in analysts' earnings forecasts. Sometimes a minor rise indicates materially improving prospects. A trivial reduction can signal noticeably eroding business conditions. The stock price responds accordingly. Single figure estimates tend to cluster together and usually reflect the published management guidance. Still, earnings estimates are a good means for investors to get a handle on Street expectations and the general magnitude of earnings growth.

A Lone Wolf Analyst with a Unique Opinion Is Enlightening

There is serious value added in a unique perspective that is contrary to the crowd. Often there are no hard numbers or evidence to clearly indicate cracks in the surface. A shift to a negative stance that is all alone is a noteworthy signal. Other analysts maintain their favorable views and pooh-pooh the dissenter's conclusion. He is castigated, dissed by executives, attacked by major institutional holders of the stock, and feels like an outcast. These repercussions are anticipated, and that's why a dramatic rating slash is always brutal for the analyst. When an analyst is so courageous and willing to stick his neck out with a minority viewpoint, he is displaying a certain conviction. The view is enlightening, as the justification presents evidence that the preponderance of bullish advocates are wont to admit.

The Best Research Is by Individuals or Small Teams

Individuals and small teams concentrate on a modest range of stocks or a limited segment. Research analyst teams are universal, but the big team approach has been overdone and a shift back toward more individual coverage seems warranted. Teaming enables a far deeper level of detail, earnings models, the nth degree of information, and more immediate response to developments. There are enough bodies to do in-depth reports. The problem is that investors, the sales force, traders, and all the other audiences are unable to absorb this amount of trivia. Analysts get sidetracked, bogged down in all the fine points. It's overkill. Teams are a conundrum for analysts. They both free up

senior analyst time from minutiae to ponder bigger picture trends, and also require more attention to details and necessitate oversight, review, coordination, and supervision. The Street is trending toward smaller teams tracking more stocks per person. This is commoditizing research, as analysts are burdened with a greater breadth of coverage. Junior, inexperienced analysts are conducting the research. The heavyweight senior analyst spends most of the time marketing, meeting, and calling on institutions. Analysis is a mile wide and an inch deep. It should be quality, not quantity, that counts.

Analysts may be error prone if they are not concentrating on a narrow industry segment. During my eight-year span at Salomon Brothers in the mid-1980s, I covered the entire computer industry. The mistake was that I, instead of specializing, was attempting too broad a reach. I learned a valuable lesson. I didn't think to specialize in computer services and software until three years after the establishment of a separate category for that sector in the preeminent annual *Institutional Investor* (*I.I.*) analyst poll. Once I made that shift, I immediately vaulted to a #1 ranking and retained *I.I.* All-American team status for 19 straight years.

On the other hand, narrow sector concentration can cause more bias. If analysts cover too few stocks, they have no alternative stocks to recommend when their group sours. While the current Street norm of broader coverage by less-seasoned analysts may leave them open to mistakes, the flaw in the opposite approach is that analysts with a field of coverage that is too limited tend to have a constant positive stance. They can't be left without anything to propose to investors, and institutions do not want to hear negative views on the stock they own.

Overconfident Analysts Who Exhibit too Much Flair Are All Show

Arrogance, showbiz, flair—analysts are noted for these characteristics. They need to demonstrate excessive confidence to the sales force and important institutional clients to display the strength of their convictions. Any hesitation is interpreted as doubt and impacts credibility, just as it affects a politician. We learn quickly to be accomplished

actors, even bluffers. We talk fast, connoting a (false) air of assurance. The amplitude of our belief in stock recommendations, forecasts, and assessments varies widely, is sometimes even lacking, but our audience would never know it. And we have such extensive knowledge of the companies we cover that we are supreme at faking answers to questions, if necessary, to preserve our omniscient image. This is a pernicious practice, as investors can be readily swayed, and analysts might be spectacularly wrong. That was the hallmark of the '90s Bubble Era.

It should be clear upon realizing Wall Street's well-kept research secrets that the Street is not a reliable source for objective stock recommendations. That's really not its job. Sure, the Street postures that it can provide investment advice and financial counsel. But it is structured to trade securities, perform securities transactions, distribute and sell securities as a dealer, and do corporate finance deals. Wall Street is not suited to be an investment manager, financial advisor, or stock selector. In fact, these services that it purports to offer are a conflict of interest with the bedrock brokerage and banking functions stated previously. The Street does not intentionally mislead—there is no deceit—it's just the way the business operates. Therefore, don't take the Street's directives literally, be aware of its shortfalls, and invest with the awareness of a Wall Street insider.