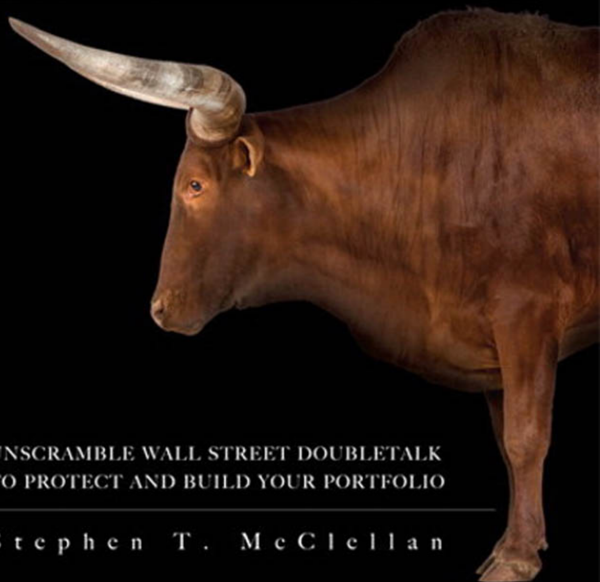
UPDATED EDITION

FULL OF BULL



UNSCRAMBLE WALL STREET DOUBLETALK
TO PROTECT AND BUILD YOUR PORTFOLIO

Stephen T. McClellan

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Preface

This book is for the individual investor. It is all about investing, not trading, because investing is the way to make money in the stock market. Unfortunately, transaction-oriented Wall Street tends to discourage and even hinder proper investing. Broker investment advice can be misleading, even contradictory. Professional insiders know better than to take the Street literally. You need to take the same approach. This book will show you how to avoid Street pitfalls, circumvent inappropriate research guidance, correctly interpret Wall Street commentary and opinions, properly assess statements by corporate executives, and put news media reports in their proper context. It will provide you with an understanding of the confusing ways of Wall Street so that you can make more profitable long-term investment decisions.

Full of Bull was first published in hardcover in late 2007, and slight revisions were made for the second printing released at the beginning of 2008. In early 2009, I made extensive updates for this paperback version. I also added a new chapter discussing bear market investing. During 2008, one of the worst bear markets since the Great Depression gripped investors. Those who did not react by preserving capital—my foremost investment strategy—lost as much as 30% or 40% in their stock market holdings. I was frequently asked, "What should I do now?" The new Chapter 4, "Investment Strategies to Survive in a Bear Market," familiarizes investors with bear markets, the economic influence, and the role of Wall Street, and makes suggestions on how to invest during such a period.

Life sometimes shifts in unforeseen directions. For 32 years, I was consumed by my job as a securities analyst on Wall Street. My plan in late 2002 was to continue grinding away for a couple more years before hanging it up. I had no compelling new venture or life plan that I was anxious to embark on. As the stock market bubble deflated in 2000 and 2001, the economics of brokerage firm research were permanently altered. The discrediting of analysts, elimination of investment bank research subsidies, and shrinkage in commission

fees ushered in an era of parsimonious research budgets. Senior analysts were no longer being paid the vast sums of the past. At the Four Seasons Resort on Hawaii's Kona Coast, as I sat by the pool after my fifth mai tai, it hit me: I could add a couple more years of adventure to my life if I opted out. In early 2003, I tossed in the towel and concluded a long career as an analyst.

On my first day of retirement, when depression might have ensued from the new void in my life, I headed off to Utah to ski with my son and attend the screening of my daughter's new short-subject movie at the Sundance Film Festival. This marked the first time in over three decades that I boarded a plane without bringing along a carry-on bag full of work. I was savoring the prospect of perusing the newspapers and maybe reading a history book, when a guy in a suit plopped down next to me and inquired as to my business. Upon learning that I had stock market expertise, he began firing off a series of simple investment questions. After more than three decades of analyzing, researching, writing, and talking about stocks, the last thing I felt like doing on my first trip free of Wall Street was to chat about investing—especially to educate a naive, nettlesome passenger probing me for silver bullets. I quickly wriggled out of the conversation. Then a jarring realization hit me: There was a whole world of individual investors out there, struggling to make money in the stock market with little knowledge of how the Wall Street investment game is really played.

Over the following two or three years, I filled up a notebook with observations and insights that might be useful to an individual investor. My previous book, *The Coming Computer Industry Shakeout,* which I wrote in the early 1980s, concluded with a brief chapter on basic principles for individual investors. Although rudimentary, it made a splash with readers and the press. This time, with *Full of Bull,* the entire book is devoted to such investment maxims. My style is opinionated, forthright, and direct. My views may be controversial, but I try to emulate the revered sportscaster Howard Cosell and "tell it like it is." These are my own conclusions—acquired during my decades on Wall Street.

I grew up in Wilmette, Illinois, ran track at New Trier High School, and tooled around in a jeep delivering newspapers each summer. I was initially intrigued with the stock market and Wall Street in college at Syracuse University, so I buttressed my liberal arts economics major by

taking additional business and finance courses. When I heard that a two-person stockbrokerage firm in Chicago might be in need of summer help, I leaped at the opportunity. Morton D. Cahn was an octogenarian and the most senior member of the Midwest Stock Exchange. His halcyon days had been the 1920s, but in the 1960s, he still kept a tiny one-room office running and spent his days on the exchange floor doing maybe a dozen trades a day. All summer in that office, I devoured every facet of the business—calculated commissions, messengered securities around the city, took transaction orders over the phone, studied a text on bonds during my downtime, and handled the office all alone when the old-line office manager was away on vacation. By Labor Day, I knew my career would be on Wall Street.

Some of the paychecks I collected from that stint were destined to be invested. I was eager to become an honest-to-goodness stockholder myself. My dictatorial father, who was springing for my college expenses, vetoed the idea. But I was adamant and put in a buy order for five shares of Union Carbide at $91. When I divulged my "shareholder" status to him, he was furious. But I was unyielding. I guess I was coming of age and beginning to stand up for myself. Every day during my senior year at Syracuse, on shirt cardboards, I recorded Union Carbide's opening, high, low, and closing prices and its trading volume. I cared. You cannot imagine the satisfaction I felt every three months when I received my dividend check for $6.25. And the next summer, I sold the shares for over $109—my maiden investment had produced an inspiring capital gain!

In those college days, New York City was our venue during Thanksgiving vacations for jazz clubs, hockey games, and other cavorting. But I spent Friday (the market being open) wandering around Wall Street as an anxious outsider wanting to become an insider. I haunted the New York Stock Exchange, the American Exchange, Trinity Church, the streets, bookstores, and even brokerage lobbies. My buddies were dumbfounded that I would waste a day of our precious, exciting school break in Gotham trolling the canyons of Wall Street. For me, though, it was Priority Number One.

Later, as an operations officer in the Navy, aboard a ship based in Norfolk, I devoured *The Wall Street Journal* when in port, scrutinized *Forbes* magazine while on watch, compiled a notebook of research, and planned my strategy to reach Wall Street. I had a meager few

hundred dollars invested in one or two stocks. Shortly before mustering out of the military, while preliminarily knocking on Wall Street doors, I received some emphatic counsel from a Merrill Lynch personnel-department interviewer. He told me I needed an MBA degree if I hoped to get a job in the business (as if I could run across the street, grab a graduate degree, and be back that afternoon!). The prospect of three more years in school before reaching the Street was daunting.

So, during the late 1960s, as the Vietnam War raged, I donned my uniform, interviewed, and was rubber-stamped at George Washington University Business School, where my dad had earned his law degree in 1929. Upon settling in Washington, D.C., I landed a position with the U.S. Department of Commerce. There, I assisted the existing office equipment industry analyst, a senior veteran who called me his amanuensis. He showed me the basics of how to write research publications. I was immersed in tracking and publishing reports on the rising computer industry. Three years later, MBA in hand, I blanketed Street brokerage firms with letters seeking interviews. With no clue as to what specialty I preferred—institutional sales, trading, investment banking, or research—I haphazardly tossed around my glossy résumés. One boutique firm, Spencer Trask, a small, respected, research-focused brokerage, noted my computer-industry expertise and ushered me upstairs to the research director. His offer to hire me as a junior analyst was the only one forthcoming. I took it instantly, starting at an $18,000 annual salary. The MBA turned out to be irrelevant; familiarity with the data processing field was the trigger. Life is strange.

My debut day in 1971 was eons removed from my walk-off in 2003. The first six years on Wall Street was a massive learning experience. At Spencer Trask I was mentored by the electronics analyst who hired me, Otis Bradley; soon I became a full-fledged analyst myself and enjoyed a coddled existence at this old-school, genteel, white-shoe firm. In 1977, I made a leap to Salomon Brothers, an aggressive, trading-oriented, highly profitable firm endowed with stellar professionals and a recognized, confident élan. It was a cauldron, but it introduced me to the changing real world of Wall Street. After 8 years, I slid over to Merrill Lynch and stayed there for 18 years. At the time I was signed, Merrill was becoming a heavyweight in

research, a household word, a leader on Wall Street, and a good place to be as an analyst. At Merrill I achieved #1 status in *Institutional Investor* magazine's analyst rankings for several years, moved to the West Coast in 1991, and operated from San Francisco for the remainder of my career.

Once, after I was retired, a casual investor mentioned to me, before a round of golf at our club, that he was about to purchase a particular stock in the aerospace-defense sector. His justification was something like "nine Wall Street Buy recommendations and only one Neutral, all the favorable Street opinions have been in place for a year or longer, and the consensus price objective is some $18 above the current level." He obviously believed all this Street talk, having no idea that, given precisely the situation he described, perhaps he ought to be *avoiding* the stock.

As a Street professional, I interpreted the situation such that the one lonely Neutral stance was really a Sell indication (probably insightful and timely) and should be given more credence. Street analysts use the terms Hold or Neutral to subtly indicate a negative view. I also thought that all the Buy opinions were likely growing stale, so there might be more downgrades ahead shortly. My golfing partner was late to the party and had undoubtedly missed the big gains in the stock. Furthermore, I assumed that those analyst price targets probably had been boosted a couple of times already to justify the continued Buy ratings. My skeptical assessment was probably shared by almost everyone on Wall Street, but my golf bud, being a typical individual investor, misinterpreted the situation. From all my years on Wall Street, I understand that the key to superior investing is in decoding the Street's confusing (if not misleading) doubletalk and ignoring and sometimes even defying its advice. Nevertheless, most investors fall right in line like true believers.

My golfing friend and I, when it came to investments, did not speak the same language. Wall Street directs its advice to the managers of big mutual fund portfolios and hedge funds. Similar to a baseball manager talking to his players or other league officials, the Street assumes that other professionals in the business understand the nuanced manner in which the game is played. It knows that they are able to use research material appropriately (that is, not take it literally), and it expects insiders to react in a certain manner.

The individual investor is often misled by Wall Street's ambiguous ways. What investors are missing is the knowledge necessary to deal with the Street. Individuals need to put the deluge of stock information in the proper perspective and make their own investment decisions. It is not enough to tap into the Internet, tune into CNBC, scan the financial section of the newspaper, devour magazines like *Money,* listen to a broker, or even read the typical book on how to invest. Keeping in touch with all these sources helps, but the information must still be utilized effectively. The misleading actions of Wall Street must be taken into account. What should you make of a Street recommendation upgrade from Sell to Hold or Neutral? If a stock is downgraded from Buy to Neutral, should you hold it or sell it? After a stock-price target is reached and the target is raised, the Street tells the investor to continue buying. Wasn't the initial target real? And if so, should not the investor be told to Sell when the objective is achieved? You get the picture. You do not have a chance unless you can decipher all the confusing, unpredictable, and often counterproductive Wall Street babble.

The purpose of this book is to expose the puzzling and deceptive behavior of Wall Street that so disadvantages individual investors, tripping them up in their attempts to invest properly and rationally. It unscrambles the confounding practices of the Street in terms a layperson can comprehend. The reports by securities analysts are highly useful as background research. Analysts are steeped in company and industry expertise; they can provide helpful commentary in reaction to events and news; and they publish earnings estimates. But an investor needs to know what to discount in Street research—how to separate the wheat from the chaff. An individual investor must grasp how the system works and be able to factor it into his or her investment approach. Once armed with an insider's understanding of all the Street's subtleties, you can be your own investment analyst. My strategies will equip you to evaluate companies, select stocks, and take advantage of your position, one free from the many constraints that inhibit professionals.

To stay abreast of my current stock market investment views, go to my blog at www.stephentmcclellan.com. There you can also read articles and interviews and browse my appearance schedule.

Stephen T. McClellan
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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. Wall Street operates in strange, ambiguous ways that it would prefer to keep secret. Do what Wall Street does, not what it says. Do not take the Street literally. Its research cannot be trusted. Corporate executives react to Street sentiment, attempt to influence their own stock prices, and also deter objective investing. The individual investor is an afterthought, mostly neglected by analysts and broker-dealer research departments. The Street cannot be ignored. But if you understand the research game to the same degree that professional portfolio managers do, the playing field will be more even. By unscrambling Wall Street doubletalk and decoding the confusing, cryptic Street practices, you can unlock the handcuffs that inhibit superior investing, to protect and build your portfolio.

Wall Street brokerage firms focus first and foremost on themselves, and after that on institutional clients such as mutual funds and hedge funds. One of the most important profit centers is the trading desk, transacting myriad trades each day as a principal (generating

profits for the house account). In his *Forbes* column, Laszlo Birinyi, Jr., who heads a financial/investment consulting firm, expresses the concern that the Street "serves itself rather than its clients…at the expense of individuals and mutual funds." He states that "an awful lot of short-term trading profit [is] swallowing up money that in the past would have ended up with long-term investors." The only way for the individual investor to offset this disadvantage is to hold stocks long-term and be aware of the Wall Street system to the same degree as the insiders.

In mid-1985, I decided to take a new job with Merrill Lynch, but first I had to sit tight for ten days. I was scheduled as Louis Rukeyser's guest under the Salomon Brothers moniker and could not resign gracefully until off the set of *Wall Street Week.* I was already feeling edgy when I arrived in the remote horse country of Owings Mills, Maryland. After I'd cooled my heels a couple hours in the studio, Lou, who had not finished writing his commentary, was still not 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 we wheeled into camera view and the hostess whispered to me, "Do not trip on the platform—three million viewers are watching."

Analysts like me are not accustomed to being grilled. We normally have the upper hand. At least we are good at faking aplomb and we rarely come unraveled. 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. This book puts you in Rukeyser's shoes. It unravels Wall Street security analysts and their research. And it will give you investment strategies to counter the Wall Street bull.

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 his or her 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 12 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), and 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, because 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 toward focusing on software and computer services in the 1980s, and then covered only computer services starting in the 1990s (companies such as 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 such as the financials, products, competitive position, management, strategies, and research and development. Analysts must be able to judge executives; assess the impact or effect of any number of influences, such as competitor pricing or a demand falloff on a company; have the vision to see the big picture amid 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 about the computer industry while employed at the U.S. Department of Commerce tracking the sector there. Wall Street recognized my knowledge of the area and hired me for that reason, not because of my MBA degree.

The second-most-important analyst qualification is an understanding of the stock market, investment, and securities (stocks, bonds, options, convertibles, and so on). This is basic stuff, things such as listed versus 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 knowledge 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, when I first began 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 such as 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, such as the in-house sales force and traders on the desk and the outside media. Notice I left out retail individual investors. Analysts do not deal with them directly. Analysts on Wall Street must sell their research, that is, market their product and views. 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 need to be convincing on the telephone and over their firm's squawk box. They must have conviction; be strong, opinionated, and confident; and come across as cool, intelligent, and balanced, similar to a 747 airline pilot during a turbulent thunderstorm (my worst nightmare). This requires personality, charm, and a colorful and engaging character. (Of course, I was all that and more—did I mention humility?)

The brokerage institutional salespeople cater 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. All day long, they carry the analyst's research message to these institutions, in person, on the phone, or by e-mail. Salespeople might 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 sizable 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 stocks or bonds, doing mergers and acquisitions, and structuring complicated financial/investment transactions.

What is 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 a.m., 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 a.m. I rolled out of bed at 4:10 a.m., tossed on my sweats, and jumped on the horn. Because this live broadcast went out 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 a.m. Things were now happening full blast because it was 9 a.m. 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. E-mails by the dozens pleaded for responses, opinions, scheduling, and all sorts of other matters. My team was just outside my office door, wanting to chat or discuss research. No help from my administrative assistant, who waltzed in at about 7:30 a.m., 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 a.m. *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 was to report its results at 1 p.m. this particular day, after the market closed. Soup at my desk for lunch, the first thing I had eaten all day. The earnings results hit the tape. We did instant analysis, prepared questions, and tuned in to the company's 2 p.m. investor conference call. It was over at 3 p.m., and after a few minutes of pondering and quick analysis, I ground out a research report. Maybe about 5:30 p.m. I waved goodbye to the garage attendants, who gave me no credit since I did not top a 12-hour day. Alongside me on 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 pay phone while atop the High Sierras in Yosemite by Ross Perot (the other campers were impressed) and was detained by passport control officers at an Italian border 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 had the opportunity to take 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 have witnessed Michael Jordan in the NBA playoffs, gate-crashed the Cannes Film Festival, bumped into Queen Elizabeth exiting a London theater, sipped cocktails at Raffles bar in Singapore, and basked on Waikiki Beach. But there are dodgy scenarios, too. The 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 was not 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 a.m. 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 a.m., 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. She and her group found the stairwell overcrowded and exited via the elevator. To this day she is reticent to discuss her experience that morning. She 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 to be 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 are not 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 haunt the fairways. So you might imagine the awe that Augusta inspires in a mediocre duffer like me. When the chairman of an Atlanta-based software firm, John Imlay, part owner of the Falcons NFL football team, inquired about 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 would also be motoring to Augusta afterward 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 cannot 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 logoed stationery from 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 was not a bad locale to chat up management.

The most trying aspect for securities analysts on Wall Street is dealing with a sense of vulnerability to anything that might impact the stocks they cover. The fear stems from realizing that at any time during a business day, a company under coverage might announce dramatic, surprising news, such as a shortfall in earnings or loss of a major contract. An analyst in this circumstance must scramble to assess the situation, then jump on a conference call, and respond to an avalanche of inquiries from the sales force and investors. This is difficult enough if the analyst is in the office with all necessary resources at hand. It is a disaster if it happens when the analyst is on a tightly packed all-day client meeting trip, 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 or iPhones and call in periodically every business day, just like a doctor on call.

After you appreciate the basic function and role of Wall Street investment analysts, you need the rest of the story—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 after the strange, deceptive ways of Wall Street are demystified.

Wall Street Analysts Are Bad at Stock Picking

It might be shocking but stock picking is not the analyst's job. Until recently, brokerage firms did not even track the accuracy of their analysts' opinions. It is just not an important part of the analyst's 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 is 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.

It is not just opinion upgrades, or Buys, that are unreliable; downgrades, or Sells, are also frequently unavailing. In December 2007, a major brokerage firm lowered its Buy rating on Countrywide Financial, a company in the crosshairs of the subprime mortgage debacle, to Neutral after the price had already plummeted from $40 to $9.80. Another high-profile firm underscored its $110 price objective for Bear Sterns while the shares were trading in the $50s, three days before the stock plummeted to under $3 in a JPMorgan Chase bailout. In May 2008, the high-profile oil analysts at a leading firm forecast the price of oil to reach $200 in the ensuing two years. By September the revised forecast was $148 after the price had sunk to $80, and in October the estimate was cut to $86, always following several steps behind the plummeting oil prices. (Oil had cratered to $40 by December.) There were several Buys on Fannie Mae the day it capitulated to $1 a share. Thank you very little! Such calls are all too typical.

An *Institutional Investor* magazine survey in the fall of 2008 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 sellside (brokerage) Street analysts. Of 12 factors ranked in order of priority, stock selection placed dead last. Industry knowledge was the key quality that institutions wanted in analysts.

The best analysts, as ranked in the October 2008 *Institutional Investor (II)* magazine poll, offered some of the worst recommendations over the past year: A leader in covering brokers and asset managers recommended Bear Sterns in January at $77. Eight weeks later it was selling at $2. The number one–ranked insurance industry analyst reconfirmed his long-standing Buy opinion on AIG in August and retained his favorable view until the federal seizure at $3 a share in mid-September. The top-rated analyst in consumer finance pounded the table, enthusiastically endorsing Fannie Mae and Freddie Mac right up until their government takeover below $1 a share.

When stocks have several Sell recommendations, there is nowhere else for that stock to go but up. When 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. For years, *The Wall Street Journal* published a quarterly dartboard contest. The expert stock selections made by analysts and portfolio managers did no better than those picked randomly. 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.

Mutual fund money managers are no great shakes either. In the 2007 *Barron's* Roundtable, which brings together 11 leading Street stock experts, only four had more than half of their top choices outperform the market. Daunting. In 2008, some 56% of the 72 total picks outperformed, though only 32% showed a gain in absolute terms, and half of those were currencies, commodities, and other nonstocks. More than one-third of the selections collapsed by at least 50%. Quite a statement on the ability of Wall Street to pick stocks.

If that is not enough proof, Charles Schwab rates stocks A to F. From May 2002 to October 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 2005. You have 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 farther

down the list. Pretty much the same pattern held true when performance was evaluated over a four-year term. The Street pushes analysts to emphasize institutional hand-holding 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. The system encourages this by compensating analysts for profile, status, clout, and industry/company knowledge rather than for their 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 than most of the green Internet analysts, he should have known better than to engage in overt cheerleading of his banking clients. Apparently he did not, as evidenced by his statement in a *BusinessWeek* quote about his actions: "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 is now permanently barred from the business.

Analysts' 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 would be unable to 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. 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 was no help to investors who might have believed the opinion called for purchasing the stock for its appreciation potential. 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), as rubrics to convey a negative stance to their key client base, institutional investors. They avoid the more pessimistic classification levels such as Below Average, Underweight, Underperform, 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 is negative. It helps the analyst save face.

The current almost-universal three-level investment rating scheme is fraught with confusion and disparities among different firms. Investment recommendation jargon needs to be clearer and more consistent throughout the Street. Does Overweight mean Buy? *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?"

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 that the stock might rise anywhere from 10% to 25% in the next 12 months. According to the *Journal* article, at Bear Stearns an Outperform implied that the stock would do better than the analyst's industry coverage. At Smith Barney, a Buy connoted an expected total return of more than 15%. A Buy at UBS Warburg meant it would rise 15% or more over prevailing interest rates. Thankfully, some firms have finally gone to just one investment rating time frame, eliminating the near-term and long-term tandem that was often a conundrum. But there is a long way to go to get the industry's investment rating systems on a similar page.

In mid-2008, a major brokerage firm shifted its policy to help bring some balance to its universe of ratings. To encourage more negative opinions, it started requiring its analysts to assign an Underperform to 20% of all the stocks under coverage. At the time only about 5% of all Street recommendations were Sells. But confusion persists since the firm's definition of Underperform is "the stock will either fall within 12 months or rise less than competing companies with higher ratings." This means the stock might either go up or go down—not very enlightening.

It is 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 is hesitant to upset vested interests with the dreaded Sell word. The latter is usually the case. The Street normally interprets Hold opinions negatively. So should the individual investor.

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.

Wall Street investment advice is further blemished by being risk adverse. Obfuscating is pervasive, stemming from 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. This is equivocating. In a simpler system, the analyst might carry only the Neutral recommendation. That way, he can dodge responsibility no matter how the shares perform. If the stock spirals lower, you will hear, "I was not really recommending it." Conversely, if the shares climb, there will 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, credit will be taken for those stocks that ascend. A ready excuse is offered for any of those whose prices meander, that the name was not among the top two or three best picks.

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 that 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 at the same time in pacifying relationships with institutional holders and corporate executives. Forget using Buy/Sell—too crass, politically unacceptable. Under such a simple system, the analyst view on the stock would be more clearly communicated, and the accuracy more readily tracked. But do not expect this to ever happen. Wall Street would never deign to be that accountable.

For the sophisticated institutional audience, I would go a step further, and remove investment ratings altogether. 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 could lower an opinion without incurring the wrath of big holders and corporate executives.

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 might have 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 out of favor and not being widely recommended, that represent value, and that might eventually attract opinion upgrades.

Research Never Contains an Analyst's Complete Viewpoint

Because reports are in the public domain and are read by all the analyst's disparate audiences, 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 an analyst's research report. 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 is never revealed in writing. Although analysts are no longer legally able to have a stance that conflicts radically with the one portrayed in the report, there is much left to be read between the lines.

Wall Street Has a Congenitally Favorable Bias

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 have never heard them tell consumers to "sell." An article by Clifford S. Asness in the *Financial Analyst Journal* makes a similar comparison. He accurately states, "A large part of Wall Street's business is selling new and used stocks and bonds, which strangely they do make recommendations about."

The Street rarely espouses bearish views on the very products it wants to sell to clients. No matter how deep the bear market or how clouded the outlook, brokerage firms want investors to continue investing in stocks. A leading firm emphasized in its February 2009 magazine to investor clients, "Defensive investing does not mean staying out of the markets. Look for conservative opportunities." John C. Bogle, founder of the Vanguard mutual funds, claims: "Our financial system is driven by a giant marketing machine in which the interests of sellers [Wall Street] directly conflict with interest of buyers [investors]." Fifty percent of all trades are sales, by definition. Yet more than 90% of all research is directed at buyers, positive Buy recommendations, or Holds.

The press also leans heavily to the optimistic side. Entering 2008, amid the worst bear market since 1931, the leading financial magazines featured cover stories such as "Your Comeback Year—2009," "Get Your Money Back—A Six-Step Plan to Rebuild Your Savings," and "Yes, Things Are Grim, But Here's Your New Plan to Emerge Stronger." Even the venerable *Barron's*, in advertising the debut of its new newsletter, emphasized that it would present an "investment idea each day…90% of the calls will be bullish." Wow, 225 Buy recommendations a year—one every business day! And almost all Buys, even in a bear market. That same publication features an annual market forecast by 12 leading Street investment strategists. At the outset of 2008, the panelists' S&P 500 predictions for the year ranged from 1525 to 1750. The end result was an astonishing miss from the actual 903 at year's end. The dozen 2009 forecasts for the S&P 500

were again universally bullish, from 950 up to 1250, despite the bear market scenario.

Wall Street is totally oriented to a rising market and upward-moving stock prices. The common terms used 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 is called a "correction." When the market rises, the Street does not call it a "mistake." "Volatility" and "turbulence" are other terms that often surface 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 is seen as "stabilizing," a favorable description. But if stocks are soaring, the market is never portrayed as being unstable. When the economy dips into recession or the employment level falls off, it is termed "negative growth." The government is the same way. When Ben Bernanke testified before Congress, he refused to use the R-word (recession), instead referring to a "contraction" of the economy.

The Street just keeps trying to sugarcoat or neutralize the situation even when stocks are diving, as during the 2008 bear market. As *Barron's* described, its attitude is like the federal government's: "Fundamentally everything's fine…not to worry, it'll soon get better." Or "Wall Street…enjoys singing in the rain without an umbrella, hoping to lift investors' spirits—and, just coincidentally, brokerage commissions and positions—by pretending to espy nonexistent rainbows, accompanied, of course, by their obligatory pot of gold."

Most institutional investors hold stocks, long positions, and rarely sell short or bet on a decline. Analysts are given incentive to issue Buy opinions by the favorable feedback that flows from major institutional owners of the stocks and from corporate executives. They are discouraged from expressing negative views by the adverse reaction and often disparaging remarks that follow from these constituencies. In fact, when organizations are holding several million shares of a stock, you can imagine their reaction to a Street downgrade that drives the price several points lower. These organizations have portfolio managers who make stock selections; they do not need Wall Street analysts for that purpose.

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 as 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 6 Sells. Systemic bias? Analysts' opinions are swayed by vast brokerage investment banking opportunities with these major corporations. The system is stacked against negative recommendations.

Analysts have a tendency to fall in love with the companies and stocks that they are advocating. It is like identifying with your captors. Human instinct. Their bias is ineffaceable. Some of this insanity was eliminated when subservience to investment banking was reduced. But do not 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 Internet bubble, Salomon Smith Barney had only one Underperform and no Sells among the nearly 1,200 stocks it was covering. According to Zacks Investment Research, of the 4,500 stocks it tracked in the fourth quarter of 2005, amid the ongoing bull market, 42% were rated Buy or Strong Buy. Only 3% carried Sell or Strong Sell recommendations.

At the end of 2007, after a notable stock market drop, the distribution of Wall Street research opinions was 49% Buys, 46% Neutrals, and only 5% Sells. During 2008, the number of hedged, unhelpful Neutral or Hold Street opinions skyrocketed as stock prices nosedived, but Sells remained scarce. By the end of January 2009, some 16 months into the bear market, according to Bloomberg data, there were still less than 6% Sell recommendations on the Street, compared to 58% Neutrals and 36% Buys. In randomly glancing at a February 2009 research report on a healthcare company, I noticed the analyst carried 17 Buy ratings on the 28 companies covered, more than 60% favorable views despite a bear market. This is typical. The major brokerage firm that altered its opinion rating system in 2008 required its analysts to rank at least 20% of the stocks under coverage

as Underperform (Sell). That led to 31% of all the stocks covered by the firm being rated as Sell, an admirable balance compared to the rest of Wall Street; but it still left 69% of the coverage universe with ratings of Buy or Neutral during perhaps the worst bear market since the Great Depression.

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 those of analysts from brokerage firm investment banks. The record is about equal during bull markets when Buy ratings are prevalent. But independents stand out in bear markets such as 2008, when they promulgate more negative views. Brokerage firms are reluctant 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. Studies prove that the analyst at the brokerage that leads a company's initial public offering provides noticeably more affirmative coverage than analysts at firms unaffiliated with the deal.

Downgrades Are Anguishing, Arduous, and Rare

Analysts are reticent to downgrade opinions, fearing institutional holder retaliation. Buyside analysts and portfolio managers are most generous in voting commission allocations to the sellside analyst firms who help tout their stocks. These institutions vent their fury and banish brokerage analysts who downgrade ratings on the stocks they own. This anticipated punishment is a critical constraint when pondering an opinion reduction.

When reducing ratings, analysts come under so much criticism that our argument must be airtight. It is discomforting to reduce an opinion after the stock has already started to fade. This creates more hesitation. Like the monkey that sees no evil, we close our eyes to initial negative developments. By the time the weight of negative evidence is exceedingly compelling, most of the damage to the stock has already been done. When analysts finally capitulate and go to a full-blown Sell opinion, the stock has likely already hit rock bottom.

Although patience might be required, there is usually more upside potential in the shares at that juncture for an individual investor than further downside vulnerability.

Brokerage firms have made the procedure of altering an investment rating hugely more complex for the analyst because of regulatory and legal issues. That was a consequence of the pathetic stock recommendation record after the 1990s bubble burst. Investment research committees meet at certain intervals, require burdensome reports and documentation, and grill the analyst, and then after all that, legal compliance gets involved. There is a lot of second-guessing and attention paid to current stock price trends, rather than a longer-term investment time horizon. Changing an investment opinion is a frustrating exercise. And the analyst needs to be ensconced in the office to jump through all the hoops—forget being on the road. It is just easier to do nothing. Opinion changes are hardly worth all the effort. Analysts thus resist upgrades and downgrades. Ratings that might be inappropriate remain intact out of inertia.

Early stock opinion downgrades are infrequent. Taking a negative stance and lowering an opinion is like a divorce—it might be necessary, but it certainly is unpleasant. But such dramatic calls are telling, if coming from a veteran analyst highly credible in covering the stock. After more than 16 years of superb execution and fabulous stock performance, EDS laid an egg in 1996, almost immediately after regaining its independence in a spinout from General Motors. The company's quarterly earnings results ran across the newswire, vastly below Street expectations. My instinct told me something was terribly amiss, and my reaction was immediate. In this case, there was no prolonged torment, no deliberations, committee meetings, or soul-searching. I summarily downgraded it with no time to ponder the consequences. It was an emotional, traumatic situation, and, given my reputation and prolonged bullish view on the stock, it had a incendiary impact. The company and its shares performed pathetically over the ensuing three years. This rating drop happened so abruptly that it was actually easier to effect than most reductions. But even this good call was after the fact; the bad news had already hit. That was more than ten years ago. In this new era of heavy compliance oversight, such a quick reaction and opinion change is rare or impossible.

Sell opinions, especially if in the minority, put us on an unpleasant hot seat. If an analyst shifts an opinion to Sell, only a portion of the relatively few owners of the stock might take the advice, pull the trigger, and generate a commission. The majority of other investors do not care. An upgrade to a Buy, on the other hand, can be marketed to virtually all investors, and the potential to create transactions is expanded by orders of magnitude.

Most Downgrades Are Late; the Stock Price Has Already Fallen

Most opinion reductions are "me too," the fourth or fifth such recommendation on the Street, and all copycats after the dismal outlook has been highly evident for some time. The shares have usually already fallen 25% to 50% or more, and have fully discounted the plethora of bad news. In 2008, such belated, useless downgrades happened over and over with Lehman Brothers, Bear Stearns, AIG, Fannie Mae, GM, and countless other dogs. Almost all downgrades are late and represent the final capitulation. After most of the ratings have been downgraded, it might be a good buying entry point for a patient investor. After most Street analysts are pessimistic, the share price has only one way to go—back up.

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 fervently recommended, effectively pounding the table to entice investors to amass major positions. This ardor is self-fulfilling. Research analysts are overconfident. The more proficient analysts that 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. As a result, the stocks can ascend to artificially high, unsustainable levels. The opposite is true for infrequent Sell opinions. We exaggerate 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 and make our negative view all the more correct. In both situations, analysts overstate their positions. Stocks swing in both directions far beyond what is warranted, because analysts overstress their stances. Investors should sell when analysts get overly enthusiastic and likewise 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 concentrate 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. Big companies are where most investment banking business is derived and where 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 and 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 and 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.

Executives and board members have a similar preference for bigness—they hesitate to do spinoffs, 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 megamergers never work. Most analysts at major firms get attention and make their reputations by emphasizing big cap recommendations. Brokerage revenues are decidedly boosted by outstanding calls (a rare event) on broadly held stocks, not small caps.

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 sizable positions in stocks. Though they might invest in some smaller cap stocks, even a spectacular winner will have 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. Even if a table-pounding Buy recommendation causes a small cap stock to soar 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. There are meager economic payoffs for a brokerage firm in recommending small stocks, whether for trading, banking, or commissions. Small stocks thus 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 Not Credible

Most brokerage firms sport their top stock picks in a high-profile emphasis list. Carrying titles such as Focus List, Alpha List, and, my favorite, Americas Conviction Buy List, these exalted rankings are really just amateur hour. Although Street firms often flaunt statistics showing that their Buy collections outperform the market, these "best" recommendations do not perform materially better than all the other favorably rated stocks lacking such lofty 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 is not 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!

In mid-2007, the results were still dismal. The brokers' lists lagged the S&P 500 again during the previous 12-month span. In the rankings for all of 2007, five brokers' best Buys outperformed the market while nine lagged. During the first half of 2008, seven firms outperformed while six underperformed. The focus lists of all but one declined in absolute terms, so you would have lost money with their best recommendations. A roll of the dice probably would have had superior results.

Like a zephyr, emphasis list ideas blow in and out. Selection committees can be a charade. If a new name is needed 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 lists are maintained in a rather frivolous manner. 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 include 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 such as overall stock market trends, the economy, war, and interest rates, all of which are far beyond an analyst's 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 2007 and even in 2008.

In current sober times, the guesses might 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 for which 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. When such a target is hit, it can trigger a downgrade in analyst opinion. That impacts the stock price and has adverse short-term influence on long-term investors. Opinion changes that are based on the stock achieving a published price target should be taken lightly. Price objectives are just plain fiction.

The Street Orientation Is Extremely Short-Term

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 tyranny of the short-term and enhance portfolio performance by thinking long-term and being more patient and value-focused. Institutions are trapped on the treadmill of quarterly performance evaluations. Their investment time horizon has shrunk drastically. If a 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, and the subject of intense analyst emphasis. Annual earnings estimates are highlighted by expectations for the existing quarter. And it is this shortsightedness that gives the individual investor an opening. As an individual, you can invest and hold stocks for at least two or three years to improve performance results, because you are not being judged on a quarterly basis like the Street.

Wall Street analysts are supposed to be investment analysts doing investment research. This means that their conclusions, findings, views, and recommendations should be investment-oriented, looking ahead 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 goes for the key intermediaries that analysts deal with constantly, institutional sales teams and the brokerage firms' trading desks. Mutual fund performance is tracked daily and 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 institutional clients, traders, and research management for a recommendation to prove out in a period of just days or weeks, months at the longest. And this influence pushes analysts' research to be oriented myopically on immediate results. Analysts cater to a market of traders rather than a market of investors, so they put out 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 time frame. In reality, opinions are based on how analysts think the stock might do over the next one to five months, at the maximum. If analysts do not believe that the stock will take off within the next couple of 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. Do not ever think any recommendation is based on how the stock will perform over the next year or two. We analysts get criticized if our stock recommendation stagnates for even two or three months. 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.

Wall Street's short-term time frame necessitates speed. Analysts are compelled to stress quickness over quality or thoughtfulness. The qualitative side of a company's business is more difficult to evaluate. Quality security analysis is scant since it takes too long, and analysts are normally in a reactive, hurry-up mode. Immediate interpretation of news or events is demanded. After it's 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.

Analysts Miss Titanic Secular Shifts

Another consequence of a short-term viewpoint and the herd instinct is that analysts miss titanic secular shifts. Broad industry trends last a while. Major movements such as a new technology, a different manufacturing process, or changes in consumer habits that are catalysts for a sweeping industry move are often identified by the Street only after they're in place and obvious. The theme is then underscored as the key underpinning of ongoing recommendations. The problem is that Wall Street always espouses the view that this overwhelming industry change will endure for the foreseeable future. Inevitably, a critical turning point is reached when the trend begins to subside. But it is subtle. And because analysts are momentum oriented, they rarely see the shift until it is too 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, and reacting to daily events that there is no time for studied, overall macroassessment. They might 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 will render their existing products obsolete. Analysts likewise become fixed in their coverage and views, and are predisposed to defend a favorable ongoing opinion of a recognized industry leader. 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. 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 I'd known since elementary school, then an orthopedic surgeon in Ohio, inquired innocently whether he should pick up a few Microsoft shares when it started trading. I thought that it and myriad other companies—each specializing in spreadsheet, database, operating system, and other PC software—were only a speculative flurry and a risky proposition that investors should avoid. Bill Gates's company

seemed just like the rest of the bunch and not that special. So I dissuaded my school chum. He could have retired earlier were it not for my foolish advice. These new companies were challenging the entrenched, established software for larger computers. 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 had vaulted to the most important and thriving firm of all software and computer services. And Sherlund displaced me as #1 in the vaunted *Institutional Investor* rankings. I paid the price for my oversight.

Street Research Is Unoriginal; Opinions Conform

Everything the Street publishes or communicates is excruciatingly reviewed for approval by legal compliance. Research is hamstrung, emasculated, and diluted. Pithy or controversial content is often eliminated from the research. Analysts run in packs—they herd, imitate each other, and find it uncomfortable to stand alone. 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 on the negative side. After major disappointments or shortfalls, we all belatedly change over to negative views.

Further diminishing the relevance of brokerage investment research and opinion ratings is the fact that research reaches individual investors late. Analyst contact priorities are first the sales force and traders, then the press. Stocks react when events occur and news breaks. The analyst immediately jumps on the squawk box and makes comments to the sales force. Traders get a call about the same time. (They are not supposed to be first, but sometimes they are.) After phone calls are returned 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 too 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. Their reports are useful for understanding the business fundamentals of companies and industries. Research reports detail numerous aspects of a company and provide good background for an investor, such as the earnings outlook, profit forecasts and earning models, business operations, the market, competition, issues and challenges, management, and finances.

Analysts are highly knowledgeable on the industries they cover, especially if they have tracked a particular company for a number of years. They attend briefings for company investors, participate in management conference calls with the Street, and periodically talk with company 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 expose critical elements. Because analysts have active contact with executives, they are completely familiar with the company party line, its goals and objectives, and its management style. Individual investors are rarely privy to this type of information directly, but this color can sometimes be obtained in research reports.

Analysts are good at identifying how particular events and influences could impact a company's outlook. When news breaks or an event occurs, Street analysts can provide detached, cool-headed, informative commentary. 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 on and explain such circumstances. Although such research is often rushed and tends to be a short-term interpretation, it is still 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 forecast 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 of 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 respond precipitously 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 reacts accordingly. Earnings estimates are a good way 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 true value added in a unique perspective that is contrary to the crowd. An analyst shift to a negative stance that is all alone is a noteworthy signal. Other analysts might maintain their favorable views and pooh-pooh the dissenter's conclusion. He might be castigated, dissed by executives, and attacked by major institutional holders of the stock. These repercussions are anticipated, and that is why a dramatic rating slash is always brutal for the analyst. Often there are no hard numbers or evidence to clearly indicate cracks in the surface. 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.

Richard Bove at Rochdale Research has had a 26-year career as an objective, often contrarian analyst covering the banks and investment companies. His firm is not a major investment banker for that sector, so Bove seems to have free rein to tell it like it is. A lone wolf, he was vociferously negative on the group before the collapse in 2008. In a *New York Times* story he was quoted as saying, "I do not give a damn about what the company thinks. I can say what I want about Citigroup, when I want, as long as I am honest. I was convinced that the financial industry was out of control. It just smelled, it looked, it felt like this thing was going to crash. And we kept pounding on it." An observer mentioned in the same article, "He is amongst the best pure security analysts, quite frankly, that I have ever met. He does not mince words, but his comments are founded on strong analysis." Unfortunately, the Wall Street system in the main prevents such forthright, unbiased research.

The Best Research Is Done by Individuals or Small Teams

Individuals and small teams concentrate on a modest range of stocks or a limited sector. They do not attempt to cover the waterfront, but rather do focused research on a select number of companies. Small teams tend to emphasize quality research rather than quantity. The tendency with big research teams is to generate a deep level of detail, extensive earnings models, the nth degree of information, and a plethora of reports. It is overkill. Investors, the sales force, traders, and all the other audiences are unable to absorb this amount of trivia. With big teams analysts get sidetracked, bogged down in all the fine points.

Although senior analysts should be freed up to ponder bigger picture trends, instead they spend most of their time marketing, meeting, and calling on institutional clients. Senior analysts are distracted by all the oversight, review, coordination, and supervision. Junior, inexperienced analysts are conducting the research. Analysis is a mile wide and an inch deep. Small groups or individual analysts avoid these pitfalls and their research is superior.

Analysts might 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. Instead of specializing, I was attempting too broad a reach. I did not 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 (II)* analyst poll. After I made the shift, I immediately vaulted to a #1 ranking and retained *II* All-America team status for 19 straight years.

Overconfident Analysts Exhibiting Too Much Flair Are All Show

Arrogance, showbiz, flair—analysts are noted for these characteristics. They display excessive confidence to the sales force and important institutional clients to demonstrate the strength of their convictions. Any hesitation is interpreted as doubt and impacts credibility. We learn quickly to be accomplished actors, even bluffers. We talk fast, connoting a (false) air of assurance.

The amplitude of our conviction in stock recommendations, forecasts, and assessments varies widely, but our audience would never know it. We have such extensive knowledge of the companies we cover and are expert at faking answers to questions, if necessary, to preserve our omniscient image. This is a pernicious practice. Investors can be readily swayed, even when analysts are spectacularly wrong. This is how analysts led investors astray during the 1990s Bubble Era.

It should now be clear that the Street is not a reliable source for objective stock recommendations. Sure, the Street acts as though it can provide investment advice and financial counsel. But that is not really its job. 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. These services are a conflict of interest with the bedrock brokerage and banking functions. The Street does not intentionally mislead—there is no deceit—it is just the way the business operates. Do not take the Street's directives literally; be familiar with its shortfalls, and invest with the awareness of a Wall Street insider.

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