Committee on Financial Services

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

"Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street"

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Testimony of

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Executive Summary

David W. Tice and Associates, Inc. is a company built around the idea that the most important resource an investor can have is independent analysis. Often our analysis makes our research clients and mutual fund shareholders uneasy because it differs significantly from the consensus on Wall Street. However, we believe we have their respect because they realize that our conclusions are free of the biases that affect other investment research. The BACKGROUND section discusses the organization of both our research and mutual fund management business.

We believe there is no question that Wall Street's research is riddled with conflicts of interest. The conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today that is having a corrosive effect on the marketplace. The section titled WALL STREET'S LACK OF OBJECTIVE RESEARCH HAS DIMINISHED MARKET INTEGRITY gives many examples of these conflicts from a variety of sources.

The main emphasis of our testimony will address the consequences that arise when capital markets lack integrity. This problem is much larger than whether or not individual investors are disadvantaged or suffer losses, or if analysts receive over-sized bonuses. When the market pricing mechanism that determines which industries are allocated precious resources is dysfunctional, the foundation of capitalism is threatened. When the marketplace's reward system favors the aggressive financier and speculator over the prudent businessman and investor, the consequences will be self-reinforcing speculative booms and busts, a hopeless misallocation of resources, and an imbalanced economy. Such an environment fosters a redistribution of wealth from the unsuspecting to those most skilled at this game of speculation. Our section on CONSEQUENCES addresses these issues.

In our opinion, reckless financial behavior fostered by Wall Street analysts has already caused capital misallocation throughout the high tech sector, particularly the Internet and telecommunications industries. We believe a similar misallocation is being directed toward the financial services area. Capital has been recklessly deployed to hundreds of businesses with rapid revenue growth, but with flawed business models at the expense of other viable, more important projects. A dangerous "credit bubble" has been created that threatens our financial system.

We do not claim to have the optimal solutions to these problems. In our section on POTENTIAL SOLUTIONS we suggest proposals that might help solve some of these conflicts. Being fervent advocates of the free market we are loath to advocate new regulations and more regulators to enforce them. However, we believe that the problems are so critical that something must be done. We leave the matter of specific laws and regulations to those wiser than us on these matters.

Tremendous political courage will be needed to effect change in this area. Those who have benefited from the current broken system have enormous financial resources. The raw political power of those who favor the current system cannot be underestimated. The voices of those favoring change will be faint, but well worth listening to. However, we must remember that trust in our institutions is the cornerstone of a vibrant capitalistic society, and lies at the heart of a healthy democracy.

We commend the Chairman and this Committee for tackling such a difficult and timely issue. The stakes are enormous. We are always willing to discuss the ideas presented here with any member or staff at their convenience. Thank you for the honor to appear before this committee.

Background

David W. Tice & Associates, Inc. (DWTA) operates two different businesses. The firm is publisher of *Behind the Numbers* (BTN), an institutional research service, and is investment advisor to two mutual funds. The bio and resume of David W. Tice can be found in Appendix A.

We started BTN because we were aware that institutional investors did not receive independent research from their traditional brokerage firm relationships. Certainly, Wall Street firms were not advising their clients when to "sell." In fact, while there are many independent research firms that supply services from economic consulting to technical analysis, we believe there are fewer than six other significant firms that concentrate on sell recommendations. We began issuing our own "sell recommendations" in 1988 in a research publication we call *Behind the Numbers*. Today more than 250 institutional investors purchase this product. Our 15 largest clients manage more than $2.3 trillion in assets. DWTA employs a staff of 12 analysts, 5 professionals and 10 support personnel. Of the 896 sell recommendations issued between 1988 and 2000, 598 (67%) have underperformed the market averages. As of June 1, 2001 we have 160 "warnings" outstanding. For an overview of our analytical process please see "BTN's Indicators of Weakness" in Appendix B. Actual BTN reports can be found in the Appendix C (Paging Network, Sunbeam, and Rhythms).

Since 1996 DWTA has managed the Prudent Bear Fund (BEARX). The fund currently has assets of $130 million. Prudent Bear was founded to provide individual investors with an investment vehicle to hedge their existing long exposure to equities, allowing them to profit from a stock market decline. While many funds now have the ability to sell stocks short, we believe only a handful are actually more short than long. As the market approaches more reasonable valuation levels we expect the fund to take a more balanced approach using both long and short positions. At the current time BEARX holds short positions with 67% of its assets, and put options with 4% of its assets. The remaining assets are invested in long precious metal stocks and a few development-stage companies. For more information on the Prudent Bear Fund see the "Investment Guide" in Appendix N.

It is crucial to understand that David Tice has not always had a bearish outlook on the U.S. equity market. Although he has been bearish through the later stages of this bull market, he was quite bullish on equities though the 1980's and part of the early 1990's. While working for a small investment manager in the 1980's, David was instrumental in transferring wealthy individuals' assets from real estate and energy investments into the equity markets. DWTA also manages the Prudent Safe Harbor Fund (PSAFX) which started in 2000. The fund invests primarily in non-dollar short-term, high-quality debt securities, and also invests in precious metal equities. The fund plans to benefit from a decline in the value of the U.S dollar vs. other currencies. The fund has current assets of $13 million.

In September 1999, DWTA hosted a New York symposium, "The Credit Bubble and its Aftermath" to alert the media, investors and policy makers about the risks created by the historic expansion of credit. Press coverage of the conference included a front page article in the *Wall Street Journal* and stories in *Barron's*, *Business Week* and other news media.

DWTA also hosts a popular web site, www.prudentbear.com, which includes commentaries by some of our analysts. The site also collects important news stories and commentaries on economic and financial events.

Wall Street's Lack of Objective Research Has Diminished Market Integrity

We believe the evidence that Wall Street's research lacks objectivity is overwhelming. Excerpts from news reports on conflicts of interest are presented below along with some conclusions of academic research on this matter. To illustrate how Wall Street research can ignore negative fundamentals, we provide examples of our own research and compare our conclusions to those of major brokerage firms. Additionally, in Appendix I we have supplied a table that illustrates the predominance of "Buy" vs. "Hold"and "Sell" recommendations for the NASDAQ 100.

Wall Street conflicts becoming more apparent

No one can deny that criticism of Wall Street's research is increasing. While it is true that some of those critical of Wall Street research quoted below are former analysts who may have an ax to grind, there is increasing criticism coming from such divergent groups as buy-side investment firms, government regulators and academics. When taken as a whole, it is reasonable to conclude that the current analyst/investment banker/company relationship is fraught with harmful and real (not imagined or potential) conflicts of interest. Current safeguards, such as the long-touted "Chinese Walls," are ineffective.

Two recent news articles highlight the problems with Wall Street research. Gretchen Morgenson of the *New York Times* published an exceptionally insightful article on December of 2000, titled "How Did So Many Get It So Wrong?" Her story (included in the Appendix O) provides an excellent primer for Congress on analysts' objectivity. The article includes examples of high profile analysts maintaining buy recommendations on companies that their firm had underwritten in the face of plunging share prices and overwhelming evidence of rapidly deteriorating businesses. Morgenson, for example, reports that Mary Meeker (of Morgan Stanley) maintained "outperform" ratings on 11 stocks that were down 83 percent on average. Morgan Stanley had underwritten eight of those eleven companies. According to Morgenson, high profile analyst Jack Grubman of Salomon Smith Barney (who was praised in an earlier *Business Week* article for being the telecom industry "power broker") downgraded his ratings on 11 small telecom stocks, all of which had been underwritten by Salomon, only after they had declined by 77 percent.

How could such highly regarded analysts be so wrong on the performance of the companies they followed? In Morgenson's article, Stephen Abrams, chief investment officer for asset allocation at the Trust Company of the West, suggests that the analysts are beholden to their firm's underwriting business. Trust Company of the West is a highly respected institutional investment management firm with $80 billion in assets under management. According to Abrams, "research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow. Not only are they not doing the research, they have totally lost track of equity values. And the customer who followed the analyst's advice is paying the price."

Morgenson quotes Mitch Zacks of Zacks Investment Research as suggesting that the "way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship. The way you do that as an analyst is coming out and telling people to sell a stock." Note that these damaging accusations are made by industry insiders who understand how the game is played.

In a July 2000 *Bloomberg* magazine article titled "Bad Advice," Faith Keenan presents numerous examples of analysts (again including Ms. Meeker and Mr. Grubman) refusing to lower ratings on stocks where they had a banking relationship until the stocks plummeted. Some former analysts certainly think something is amiss. Ms. Keenan quotes Stephen Balog, the former research director at Lehman Brothers and Furman Selz , "an analyst is just a banker who writes reports. No one makes a pretense that it's independent." Sean Ryan, a former banking analyst at Bear Stearns Co. explained his reasons for recommending NetBank like this: "I put a buy on it because they paid for it." Ryan said he told clients that "we just launched coverage on NetBank because they bought it fair and square with two offerings." The *Bloomberg* article is included in Appendix P.

Down with the Wall

If there was ever a "Chinese Wall" at JP Morgan, it seems to have been dismantled earlier this year. According to *The London Times* (3/21/01), JP Morgan's head of equity research circulated a memo explaining that analysts must seek comments from the relevant JP Morgan investment banker before changing a stock recommendation. Furthermore, the analyst must seek comments from the company in question, and if the company "requests changes to the research note, the analyst has a responsibility," according to the article, "to incorporate the changes requested or communicate clearly why the changes cannot be made." This article is included in Appendix Q.

One manifestation of the lack of objectivity by Wall Street analysts was the practice of ratcheting so-called target prices ever higher. In the "Heard on the Street" column in the April 12, 2000 *Wall Street Journal*, George Kelly, an analyst at Morgan Stanley who followed Cisco Systems, explained his rationale for increasing his target price this way: "We have to accept the facts of life. If investors want to be in these high-growth companies, we are just trying to take what they are willing to pay and translate it into a target price and therefore a stock recommendation." Unfortunately, this example of what we would consider negligence is not an isolated case. David Eidelman, the former head of research for two regional brokerage firms in the 1970's, suggested in the Morgenson *New York Times* article that, "analysts no longer focus on tangible factors, such as discounted cash flows, that make a stock worth what it is worth. For instance, analysts have valued Internet retailers based on how many customers they had. This may have nothing to do with earnings, they justify it with some valuation method they invented."

We are surprised that the above widely published anecdotes have not been met with more outrage in the investment community. These comments go to the heart of the problem. Wall Street is clearly not even close to being objective in the research it publishes. Several academic studies over the years have come to the same conclusion.

Academic research

One of the more important studies on analysts and conflicts of interest was published in February of 1999 by Michaely and Womack, titled "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations." We have included a sample of this study in Appendix R. The entire study can be found on the Internet at:
http://mba.tuck.dartmouth.edu/pages/faculty/kent.womack/workingpapers/boost.pdfa

In our view, important findings of the study include:

1. "In the month after the quiet period lead underwriter analysts issue 50 percent more buy recommendations on the IPO than do analysts from other brokerage firms."

2. "Stock prices of firms recommended by lead underwriters fall, on average, in the 30 days before a recommendation is issued, while prices of those recommended by non-underwriters rose."

3. "Long-run post-recommendation performance of firms that are recommended by their underwriters is significantly worse than the performance of firms recommended by other brokerage houses. The difference in mean and median size-adjusted buy and hold returns between the underwriter and non-underwriter groups is more than 50 percent for a two year period beginning on the IPO day."

4. “The mean long-run return of buy recommendations made on non-clients is more positive than those made on clients for 12 out of 14 brokerage firms. In other words, it is not the difference in the investment banks’ ability to analyze firms that drives our results, but a bias directly related to whether the recommending broker is the underwriter of the IPO.”

This last point flies in the face of claims that no conflict of interest exists between the analyst and the investment banker. In addition, the authors surveyed investment management firms and investment banking firms to determine what, in their opinion, caused the apparent bias in the research. The survey found that 13 out of 13 investment management firms and 10 out of 13 investment banking firms believed the bias in recommendations made by analysts whose firms had underwritten a stock was the result of “a strategic conflict of interest.”

Several other studies have reached similar conclusions regarding conflicts of interest. The Fall 2000 issue of the *Journal of Managerial Issues* published a study by Jane Cote, Associate Professor of Accounting at Washington State University titled, “Analyst credibility: the Investor’s Perspective.” The paper revealed that “most frequently analysts are pressured to offer favorable recommendations or at least temper negative opinions. No fewer than 61 percent of analysts responding to a survey reported personal experience with management threatening reduced future access to the company, severing business ties to the investment firm, lawsuits and even having the analyst terminated.” The study also found that, “in essence, pressures on analysts to issue favorable reports create a short-term benefit to certain constituents in exchange for a long-term cost for all stakeholders.”

Certainly the SEC has recognized a problem. Arthur Levitt, former Chairman of the SEC, stated in a December 21, 2000 *USA Today* article that analysts “have lost significant credibility” because they “operate in an area of potential, perceived and sometimes actual conflicts, their recommendations are viewed with increasing skepticism.” In her April 19, 2001 speech at the Northwestern University School of Law, Acting SEC Chairman Laura Unger noted that, “the natural incentive (as a result of the analyst working on the investment banking team), therefore, is to avoid releasing an unfavorable report that might alienate the company and impact its future investment banking business. This is not an irrational fear, either. In a recent survey of 300 CFOs, *one out of five CFOs acknowledged that they have withheld business from brokerage firms whose analysts issued unfavorable research on the company* (our emphasis).”

In May 2000, *Investment Dealer’s Digest* published the results of an analysis of a random sampling of 20 IPOs where the stock had fallen substantially since the offering. The results revealed that the Wall Street underwriters of these stocks were still recommending 80% of those companies. In nine cases, the lead or co-manager were the only ones recommending the stock.

Maureen McNichols, a professor of Public and Private Management at Stanford published a study that concluded that analysts “bow to pressure from investment bankers or clients and issue more favorable reports than warranted.” The report also found that analysts for underwriting firms had more favorable recommendations and long-term growth forecasts than analysts that were unaffiliated with an underwriting deal.

Buy-side managers, who can suffer from this lack of objectivity by Wall Street analysts, are becoming increasingly vocal on this subject. Scott Black, a well-respected investor and the President of Delphi Management, was quoted in the February 12, 2001 edition of *American Prospect* as saying, “most analysts are simply putting out promotional literature. They’re there to sell stocks and drum up other business.” Robert Sanborn, the former manager of the Oakmark fund was quoted in a *USA Today* article condemning Wall Street research. He said, “When a sell-side analyst like Henry Blodget says Amazon is worth $400 (a share) and then they bail at $30 (a share) I think it says that anyone that relies on sell-side research is an absolute fool." Tweedy, Browne Company in their May letter to shareholders lamented that "if you pardon our cynicism, many of these analysts also work for investment banking houses that are collecting generous fees for bringing Internet and Internet-related companies public. In a more rational world, this would be called a conflict of interest." Finally, Avinash Persaud, head of global research at State Street Global Markets said, "over the past five years, the quality of research has deteriorated to such an extent that many investors now view most of it as not worth the glossy paper it is written on."

IPO Mania

Actual or perceived conflicts surrounding underwriting practices during the IPO boom evidently have prompted investigations of the largest Wall Street firms, including Credit Suisse First Boston, Goldman Sachs and Morgan Stanley. Those investigating possible wrongdoing include the SEC, the regulatory arm of the NASD and federal prosecutors in Manhattan. In addition, hundreds of class-action lawsuits have been filed regarding possible wrongdoing in the underwriting process. The focus of many of these investigations is whether investment banks demanded inflated commissions in exchange for IPO shares, and whether the banks pressured large investors who were allocated IPO shares to buy more at higher prices in an effort to drive up the price of the shares in the after market.

The amount of money involved in the underwriting business is huge. The *Economist* magazine quotes Jay Ritter, economist at the University of Florida, as putting the official underwriting revenues on Wall Street for the period 1999-2000 at $7.3 billion. However, Mr. Ritter also noted that the "instant profits available for clients allocated shares in an IPO that soared on the first day of trading," totaled $66 billion or nearly ten times the amount of revenue generated by the underwriting process itself.

Recent news reports, including a story in *USA Today* (May 25, 2001) titled "Officials suspect IPO manipulation. Agencies scrutinize some investment banks," describe how Wall Street was potentially able to take advantage of the frothy IPO environment. One employee of Credit Suisse First Boston described the frenzied environment as one of "rape and pillage." Another employee said that he saw commissions as high as $1 a share cross his desk when five cents per share was more usual. "You could chart our commissions like a bell curve," he said. If these statements are true, they lend credence to the investigations mentioned above. Such activities would indicate buyers (typically institutions) were in fact rebating huge IPO gains by paying excessive commissions.

Michael Sola, portfolio manager for T. Rowe Price's Developing Technology Fund, explained *to USA Today* how the game was played. He said that "people know the higher they say they are willing to buy the stock (in the after market), the bigger the allocation they are going to get."

But why should we care that these practices go on? Aren't institutions making money for their clients? Yes, but they are doing so at the expense of individual investors and at the risk of corrupting the capital allocation system as we'll illustrate in subsequent sections. In fact, the IPO game in effect transferred wealth from individual investors to large institutions, management of the companies going public, and the venture capitalists who got out before the game ended. According to *Value Line*, individual investors own 75% of the shares in Internet companies. In contrast, individuals only own 44% of the shares of General Motors. While some institutions were selling stocks on the first day of trading, and other institutions and insiders reduced positions as the speculation continued, individuals were often left holding the bag. They had been led to believe these stocks were to be held for the long term.

In the uniformly bullish environment to which we repeatedly refer, few brokers were advising their clients to sell these speculative stocks, no matter the price. We all know the subsequent results.

This IPO mania was largely possible because of limited supply and breathtaking demand. Only a small number of shares outstanding were available in the public float since most of the newly issued shares remained initially in the hands of insiders.

The game continued, often with secondary offerings allowing insiders to get out while encouraging more small investors to come in. Thus the game continued until the bubble burst. Despite questionable fundamentals, soaring stocks in this potentially rigged game fostered a speculative environment. We are now left with the consequences of a boom turned bust.

Uniform bullishness and persistent buy recommendations with little negative commentary could very well have led to an over-allocation of individual portfolios to equities. It is certainly impossible to prove this with any available data. All we have is a mountain of anecdotal evidence. Many in our office have commented that they cannot listen to local investment shows on the radio. When our analysts hear the bullish hosts recommend people near retirement hold 80% of their investments in equities, they have a tendency to drive off the road. We do know that investors have lost more than $4 trillion, and it is our belief that the stock market decline is not yet complete. Typically, stock bubbles lead to reversals that take stocks to much lower levels. Unfortunately, the individual investor is typically late to the game, and ultimately suffers the largest losses.

Current structure puts pressure on analysts

Analysts face enormous pressure from their corporate finance investment banking teams and company managements to write positive reports on the companies they follow. As the SEC Acting Chairman pointed out earlier, one in five corporate CFOs acknowledged withholding business from firms with unfavorable reports on their companies. Since a substantial portion of an analyst's compensation is tied to corporate banking transactions, there is tremendous pressure to work closely with their firm's investment bankers to achieve harmony with the banking client. According to CNBC reporter David Faber ("Analyzing the Analysts: Taking a Look at How Analysts are Sometimes Pressured into Making Bullish Calls), analysts who write negatively about a company "get treated badly by their own bankers, by people internally." In addition, these analysts run the risk of losing their jobs.

Consider the fate of two former Wall Street bank industry analysts, Tom Brown and Charles Peabody and one current bank industry analyst, Mike Mayo. All three highly ranked analysts were fired from their positions. The reasons given for the dismissals by their former firms usually relate to mergers between investment firms. However, these three men were widely known for their strong negative calls on numerous banks during a time of frenetic merger activity in the banking industry. Clearly it would be difficult for their firms to solicit investment banking business from banks that were rated "sell" by these analysts. While numerous industry publications have speculated as to the true motives of those who did the firing, the message sent is clear. If an analyst is negative on current or potential investment clients, they should find work elsewhere. We believe that firing such high-profile, well-respected analysts has kept other analysts from making similar, useful, public calls for their clients.

Summary of conflicts

SEC Acting Chairman Unger summed up the current situation in her address to the Northwestern University School of Law, "As the Supreme Court has stated analysts should play a crucial role by providing investors with objective and independent analysis of a company's prospects. Our markets will remain strong and vibrant only as long as investors have confidence in them. Thus, it can only follow that the integrity of our markets relies fundamentally on the integrity of market information available to investors. To the extent that firms can ameliorate analysts' conflicts and better ensure objectivity and independence, all of the investing community will be better served." The text of this speech may be found in Appendix X.

Examples of independent vs. Wall Street research

To illustrate some of the shortcomings of Wall Street research, we present three of our *Behind the Numbers'* reports, and compare them to three Wall Street reports. Our reports on Paging Network, Sunbeam and Rhythms are included in Appendix C. The Wall Street reports on the same companies are in Appendices S,T, and U.

To dramatize the lack of objectivity in some Wall Street research, we have focused on two companies that eventually went bankrupt, Paging Network and Sunbeam. The point of this exercise is to show that even though there was ample evidence of these firms' financial difficulties, Wall Street either minimized, dismissed or ignored such information in their reports. As a result, investors who purchased equity or debt in these companies lost billions of dollars.

When examining the research produced by a major brokerage house on **Paging Network (PAGE)** in 1995, it is evident that routine financial analysis was set aside. The analyst upgraded PAGE to a "Buy," urging investors to take advantage of the company's solid underlying fundamentals. But as *Behind the Numbers* pointed out in a report written six months prior, the company's fundamentals appear anything but solid to the critical eye. Our *Behind the Numbers* report noted that "Wall Street has ignored traditionally important details such as net losses, heavy borrowing, and low interest coverage; and has instead focused attention on gross cash flow and revenues, two items that are almost meaningless when viewed in isolation."

The Wall Street research "justified" its position on PAGE by listing "positives and negatives" associated with the stock. While they touted PAGE for its large customer growth, its net losses and heavy borrowing were ignored and capital spending was treated like a non-recurring item. This allowed Wall Street to plug gross cash flow as a way to value the company, as if all of that cash flow was available to shareholders. But as *Behind the Numbers* points out, Wall Street's focus on gross cash flow ignores maintenance capital spending, which when taken into account, shows that PAGE is not self-supporting, but needs external funds to grow. When factoring in the capital expenditures and the changes in working capital, the net (as opposed to gross) cash flow of PAGE is routinely negative. Net cash flow shows that PAGE cannot even afford to pay its interest expense when taking into account its regular expenses. Capital expenditures for this company were in fact so high that the average customer cost the company more in terms of cash outflow than the customer brought in. So, as the company recruited more customers, it had to borrow more, which only compounded the problem.

This is only one example of how Wall Street downplays or ignores potential problems. This major brokerage house favored a company with no equity, no earnings, and that was borrowing to pay interest expense as long-term debt accumulated exponentially. The only mention of the significant leverage in the 17-page report was a single sentence, followed by another assuring investors that the leverage will benefit the company long-term. But there is no mention of the free cash flow problem. The details BTN provided are by no means the result of intense study of the company's financials by auditors, but rather common-sense observations of the balance sheet and financial status of the company by experienced financial analysts using publicly-available information. In fact, this experience shouldn't differ too much from that of the Wall Street analysts in whom investors place their trust.

Overall, it could be argued that Wall Street never questioned the increasing debt-levels or the free cash flow problem because PAGE was a voracious consumer of external funds, hence a major investment banking client. When this problem became so severe it could no longer be ignored, the company lost access to the public markets and filed bankruptcy.

Sunbeam Corp (SOC) is another example of how Wall Street was touting a stock that exhibited obvious problems when its financials were examined. SOC manufactured blenders and grills, and after a series of problems, a new chairman, Al Dunlap, was brought in to restructure. The stock reacted positively in late 1997 and early 1998 as Wall Street reassured investors that Sunbeam would emerge as a consumer durables powerhouse once Dunlap worked his magic. Large brokerage houses jumped on the Sunbeam bandwagon, blaming past problems on the old management, and claiming that selling blenders and toasters could be a high growth business.

But as time would tell, the turnaround was an illusion produced by aggressive accounting. At the time, SOC had acquired three companies, which, according to Wall Street, would allow for cost savings. In reality, Dunlap came in and took massive charge-offs. Inventory was written off in one year and sold in the next, booking no costs, while performing a series of questionable maneuvers that mismatched revenues with expenses. The result was one horrible year followed by what appeared to be the amazing turnaround Wall Street predicted. However, Sunbeam's businesses were not growing, a fact masked by the charges and other accounting gimmicks. Wall Street research was euphoric about the restructuring, predicting rapid growth for this notoriously slow-growth business. The Street did acknowledge that the consumer durables business was inherently risky, but the primary focus was on Al Dunlap and the efficiencies that were to develop from the synergies.

Again, it seemed as if analysts were taking cues from management on how to value the company and assess the growth rates. When adjusting for the charges, Sunbeam's growth was non-existent. Wall Street neglected to share this fact with investors in a 20-page report, evidently deeming the charges unimportant. In the meantime, SOC continued to take charges, in effect hiding the lack of actual growth.

Behind the Numbers was quick to depict in May of 1998 that Sunbeam's growth was in fact an illusion. Also, the goals set out during the restructuring were not achieved, as the cost savings, debt-reduction, and actual sales growth never occurred. Eventually, the short-term tricks ran out. SOC was forced to admit that its dramatic "turnaround" and earnings recovery were the result of aggressive accounting procedures; procedures that should not have gone unnoticed by research analysts on Wall Street. Sunbeam, an over-leveraged company with little growth prospects, was eventually overwhelmed by its debt.

Finally, to use a more recent example and to illustrate the gross misallocation of capital that has occurred over the last several years, we would like to discuss the rise and fall of **Rhythms NetConnections (RTHM).** Rhythms was founded in 1997 as a Competitive Local Exchange Carrier that focused on providing DSL services to business. Rhythms was started as a direct result of the Telecom Act of 1996, and Wall Street had high hopes for its success in competing against the Bell operating companies. As incredible as it sounds, the company went from being founded in 1997, to a public offering and market capitalization of almost $9 billion in 1999, to being de-listed from the NASDAQ exchange in 2001. We cannot recall another instance in the past 30 years where a company with losses of $36 million on revenues of only $500,000 was able to reach such an incredible valuation and then virtually disappear in the span of only four years. We would offer this as a textbook example of a malfunctioning capital allocation process.

Gretchen Morgenson pointed out in her previously mentioned article, "How Did So Many Get It So Wrong?" that analysts at two firms that were lead underwriters for Rhythms' equity offerings (and had received up to $3.8 million in fees) continued to recommend the stock until the share price fell below $3 (down from an all-time high of $111.50). One of those firms reinstated coverage with a "buy" recommendation in May of 2000 when the stock was at $18 with a target price of $46. The 20-page reported titled "We've Got Rhythm" devoted only a page and a half to the risks involved with the company, and devoted only two sentences in the "risks" section to the fact that Rhythms required almost $3 billion in additional funding to survive. *Behind the Numbers* wrote a report in August of 1999 that heavily criticized the company's poor financial condition. Bondholders were so skeptical of Rhythms' future that they demanded that the company hold back one-third of the proceeds from an offering to ensure that it had the resources to make the first six interest payments on the bonds. BTN's conclusion was clear, "the company's weak financial position, combined with tremendous competition going forward that could place substantial pricing pressure on its services, made Rhythms NetConnections a highly speculative investment. Unfortunately for the company's stockholders, they were unable to force the company to set aside one-third of the IPO proceeds to give them some of the same protection its bondholders received."

Demonstrating how far Wall Street was forced to reach to justify the valuation, BTN included in an update published in August 2000 this explanation of a price target by an analyst at another Wall Street firm:

> "Our rationale for establishing this new price target is based at least partially on the hard reset of the financial markets during the last two quarters. Prior to this, our 10-year DCF analysis did not enable us to reach price targets above the company's trading levels, which in fact might have been a harbinger of things to come across the broader markets." The prior price target of $80 was reached by "company comparable analysis and 18.0X our revised 2003 revenue estimate (*must have used revenue estimate because company does not expect to be EBITDA breakeven until 2004*, our comment included) discounted at 30% to reflect a high beta relative to the S&P 500."

Here was an analyst admitting that he could not justify Rhythms' valuation using traditional methods, but instead of admitting such in the reports, resorted to a convoluted methodology invented to justify the price. This behavior echoes that of the previously mentioned Mr. Kelly and his admitted actions on Cisco's price targets.

The objectivity of Wall Street analysis certainly comes into question when examining the research produced by some of the largest brokerage houses. In many cases, the analysts have become a "megaphone" for the management of the companies they follow. That is they focus on the issues and variables that management deems appropriate. While these issues may in fact be appropriate for comparative analysis, there are often important attributes that are ignored or "played down" – information that the average investor would more than likely want to know, including potential threats to the ongoing operations of a business.

Euphoria for NASDAQ 100 Stocks & Overall Market Continues on Wall Street despite imploding fundamentals

A testimony to the uniform bullish sentiment is the lofty valuation of the NASDAQ 100, the capitalization-weighted index that represents the 100 largest non-financial companies across major industry groups of the NASDAQ Stock Market. This index includes giants Microsoft, Cisco, Oracle, and Intel. To demonstrate how much risk is involved by investing in this index, we have applied some fundamental analysis to produce some valuation data.

For purposes of our analysis we excluded 11 of the 100 companies in the index that have never had earnings, and perhaps never will. The remaining 89 companies were weighted according to their market value as of June 1, 2001. Using traditional ratio analysis, we found that the average stock sold for an extraordinary 8.5 times book value and a sky-high 9 times sales. However, we found it difficult to produce a meaningful price to earnings figure, as out of the 89 companies in the group, 26 of them had losses for the trailing 12-month period! This made it virtually impossible to derive an aggregate P/E based on the methodology used for the P/B and P/S figures.

Given that in bear markets it is not unusual for the aggregate market to sell for 6 times distressed earnings (*not sales*), these stocks remain at historically high valuations – especially considering that more than one-third of the companies are unprofitable. Yet Wall Street buy recommendations account for 70% of all the recommendations on NASDAQ 100.

The table in Appendix I lists Wall Street's recommendations on the NASDAQ 100 stocks. Note how the "buy" recommendations far outnumber the "sells." Below is summary of these recommendations.

Average number of buy recommendations on each stock = 15.8
Average number of holds = 6.3
Average number of sells = 0.6

NASDAQ 100 stocks with no sells = 72
NASDAQ 100 stocks with one sell = 21
NASDAQ 100 stocks with more than one sell = 7

NASDAQ 100 stocks with more 20 buys = 31
NASDAQ 100 stocks with fewer than 5 buys = 3

Stocks of particular interest:

Check Point Software	35 buys	0 sells
Cisco Systems	32 buys	3 sells
I2 Technologies	32 buys	0 sells
LM Ericsson Telephone	26 buys	19 sells
Microsoft	25 buys	0 sells
Nextel	22 buys	0 sells

Ericsson is a stock that has already disappointed investors, and has declined from $24 to $6. The number of sell recommendations on the company (32% of *all* NASDAQ 100 sells) reflects coverage by a number of non-U.S. firms that actually issue sell recommendations.

The Nextel story is noteworthy. The company has never earned a profit yet there are 25 buy recommendations on the stock, no sells, and it trades for 4.5x sales. Meanwhile, Nextel bonds yield 12-15%, a level consistent with junk bond status. Curiously, bond investors are much more skeptical about the company's future than any of the equity analysts.

Is universal optimism justified?

Those who believe that the previous "Irrational Exuberance" has now been corrected, and they will be quick to dismiss our concerns regarding universally bullish reports and high stock valuations. Yet, despite a tempering of the historic manic excesses that engulfed the technology sector over the past 18 months, we see few reasons to hold a sanguine view of the marketplace. Most of Wall Street and the business media have been too anxious to declare a market bottom and now optimistically call for earnings rebound during the second half of the year. We see no fundamental justification for these rosy forecasts that are little more than cheerleading from Wall Street. Profit growth is in the midst of a virtual collapse, yet analysts predict a strong recovery.

In our view, Wall Street is ignoring the deep structural problems facing the U.S. stock market. Technology analysts, in particular, have repeated disregarded fundamental industry deterioration, with talk of short term "inventory corrections" and "company specific" disappointments. Repeatedly, analysts have made unjustified forecasts of imminent recovery, including a call last year to PC sales would boom due to a post-Y2K corporate buying binge and a new upgrade led by a mass Windows 2000 implementations. Telecom analysts predicted that cell phone sales would hit 650 million units in 2001. Network equipment analysts projected shortages of optical equipment for years hence. Semiconductor sales were supposed to surge a further 30%, led by DRAMS, which were expected to be in acute shortage by the final quarter of 2000.

The reality has been somewhat different. The semiconductor book-to-bill ratio is at a 10-year low. DRAM prices have plunged some 70 per cent during the last 6 months due to a massive supply glut, semiconductor sales are dropping by double-digit percentage rates, cell phone sales estimates have been dramatically downgraded to 450 million units, the optical equipment networking equipment sector is mired in a horrible glut and PC sales growth is declining Dramatically. Indeed, the rate of the decline for such PC sales growth is declining dramatically.

Against this backdrop, objective analysis makes it difficult to find compelling value in the stock market, even after significant declines in technology stocks. It is worth noting that the value of all stocks remains at a historically high 140% of GDP. This measure is down from its 2000 peak, but egregiously more expensive than the mean average since 1924 (55%), and well above the previous all-time peak of 87%, set in the autumn of 1929. The S&P 500 stands at approximately 28 times trailing earnings, the sort of valuation that one normally sees at the peak of bull markets, rather than the trough of a bear market where single digit price/earnings ratios, high dividend yields, and low price/book multiples are the norm. The valuation case becomes more suspect when analyzing specific stocks. Even after falling some 93% from its peak, Yahoo! sells at a lofty 9 times trailing revenues following a 50% sequential decline in quarterly revenues. Intel's stock has plunged, but its earnings have fallen even faster. At nearly 50 times this year's earnings, the stock is more expensive than ever.

This is hardly an environment that inspires uniformly bullish forecasts. Yet virtually every strategist and economist on Wall Street is calling for the end of the bear market. A few, including Stephen Roach and Barton Biggs speak in guarded tones about the future, but virtually every other Wall Street strategist and economist is bullish and speaking about the second half recovery. Is there a chance that strategists and economists might somehow be influenced by their employers? You bet there is! Wall Street firms make more money in bull markets than bear markets. Underwriting profits, derivative income and trading commissions are all much higher in a bull market.

We all like bull markets, but can they last forever, without creating excesses and imbalances? We don't think they can, and super bull markets turn into bubbles that must eventually pop, hurting our society. Our analysis indicates that the risk of a secular bear market has never been greater, but it concerns us that Wall Street is urging all investors to keep most of their assets in the stock market as if the risk of being out of the market is the greatest of all risks.

Just like analysts, bearish Wall Street strategists can find themselves looking for a new job or effectively demoted. We have watched several of the most experienced strategists in the business suffer this fate. It is understandable that brokerage firms would like investors to remain optimistic, but we question whether strategists should be making such bullish statements publicly as if they were stating objective opinions. This is a critical issue for millions of individual investors who are listening carefully in hopes of making sound investment and retirement decisions.

For more of our views on this stock market, see the Welling@Weeden interview with David Tice in Appendix J.

Consequences

With ample evidence that a problem exists, our testimony will emphasize the consequences of Wall Street's lack of objectivity. We will discuss five such consequences in this testimony.

1. The small investor has been financially injured
2. Fostering a culture of corporate irresponsibility
3. Capital misallocation
4. Enhanced credibility for loose or "creative" accounting practices
5. Safe haven for aggressive fund managers

However, before we begin to discuss the specific consequences listed above, we believe it is critically important to take a giant step back, and ask the questions: What is at stake here? What happens when the capital markets lack integrity and become dysfunctional?

What's at Stake

A sound and fair marketplace is at the very foundation of capitalism. It is the functioning of the market pricing mechanism that determines which businesses and industries are allocated precious resources, and it is this very allocation process that is a critical determining factor for the long-term economic well-being of our nation. When the marketplace regresses to little more than a casino, the pricing mechanism falters and the allocation process becomes dysfunctional, as we have witnessed with the recent spectacular Internet and telecommunications bubble and unfolding energy crisis. When the marketplace's reward system so favors the aggressive financier and speculator over the prudent businessman and investor, the consequences will be self-reinforcing speculative booms and busts, a hopeless misallocation of resources, and unbalanced economy. When credit is made readily available to the speculating community, failure to rein in the developing speculation risks a breakdown of the market pricing mechanism. Such an environment will also foster a redistribution of wealth from the unsuspecting to those most skilled at this game of speculation. Hopefully it is obvious that such an environment creates dangerous instability, what we refer to as financial and economic fragility.

Japan is now in its second decade of stagnation, what we view as largely the unavoidable consequence of its financial and economic bubble. Certainly not irrationally, many Japanese have sworn off the stock market for the rest of their lives. It is also worth noting that the Great Depression followed the wild excesses of the "Roaring 20's." After the crash and the revelations of the financial misdealings of the 1920s, it took decades for the American public to fully regain trust in the marketplace and its institutions. Not only is this trust a cornerstone of a vibrant capitalistic society, it is at the very heart of a healthy democracy. In our view we have begun sliding down a slippery slope. During this protracted and historic boom, Wall Street has come to possess tremendous power and influence over both the nation's financial system and economy. Clearly, this affords a tremendous responsibility on a few institutions and a relatively small number of individuals. The conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today, one that has is having an increasingly corrosive effect on the marketplace.

1. The small investor has been financially injured

There is no doubt that small individual investors have been and will continue to be injured by Wall Street's lack of objectivity, although estimating to what degree is impossible. In the early 1990's, we asked the Chairman of the Association for Investment Management and Research how the quality of Wall Street's research could be improved. He said "Most institutional investors realize that Wall Street's recommendations are based on investment banking ties and other considerations. They just wink at the conclusions on these reports and read whatever useful information might be in the report."

This attitude was somewhat reasonable before the widespread use of the Internet and proliferation of financial television programs. Prior to the mid-1990's, individual investors had little exposure to Wall Street analyst research, including buy recommendations. Now that information is only three mouse clicks away. The majority of those who use this information are at best unsophisticated, actually believing that a “buy” means the stock offers compelling value at current prices. In truth, these investors have no way of knowing that in many cases the recommendation is based on little more than expectations of future investment banking business. Twenty-four hours a day, seven days a week, individual investors are bombarded with what we view as little more than bullish propaganda.

The problem is equally pernicious for the individual investor who uses a stock broker. When a broker recommends a stock to a retail client that is not rated "buy" by his firm, he does so at great risk. If the investment turns out to be poor, he runs a considerable personal risk of loss if the client brings an arbitration case against the firm and wins. In this situation the individual broker might have to pay part or all of the loss. However, if the broker sticks to the buy list of his firm, then it is the firm, not the broker, who has the risk. The result is that very few brokers stray from the buy list. The entire world of investments not on the buy list gets no consideration. Once again these lightly regarded buy recommendations have unintended consequences.

Performance of Wall Street’s recommendations has been abysmal

We have always questioned how profitable Wall Street analyst recommendations have been for real world clients. Well, finally, results have been presented at a web site called investars.com. This group has used a carefully devised methodology to calculate the actual returns that might have been earned by an investor who followed Wall Street recommendations. This type of calculation has, necessarily, a large number of assumptions about how an actual portfolio might have been managed, but the methodology appears reasonable.

Using the period January 1, 1997 until May 29, 2001, the analysis demonstrated how only 4 of the 19 largest U.S. brokerage firms produced a positive return in a period where the S&P 500 was up 58% and the NASDAQ more than doubled. The highest total 4-year return generated by the 19 firms was a paltry 7.6%. How is this possible? Obviously, too many recommendations were made with stocks trading at unsustainable high levels. To us, it is an outrage that a system with so many conflicts of interest while can generate such dismal performance for investor clients during one of history’s greatest bull market of the century.

Clearly, Americans’ willingness to own stocks is a boon to our capitalistic system. However, when investors place their funds in the marketplace with little understanding of the risks involved in an environment dominated by bullish hype, disappointment can quickly turn to disillusionment. After the unfolding bear market runs its course, it will be a long time before the individual investor returns to the market, and the system we hold so dear will suffer as a consequence.

2. Fostering a culture of corporate irresponsibility

In our opinion, one the most serious consequences of excessive bullishness is the incorrect signal sent to corporate managements. When your stock is selling for a very high price-earnings multiple and you’ve profited from stock options while 20 of 24 analysts are recommending your stock, the message is clear:

> “You're doing a great job, but you must maintain this rapid growth or the party comes to an end.”

The message encourages aggressive behavior, providing management with every incentive to pursue large acquisitions, risky new businesses, and grow at any cost. Some may view this reckless spending as just "good old American risk-taking" We disagree. A school of economic thinking known as the Austrian School has a perfect word for the spending that occurs during the speculative phase of the economic cycle - MALINVESTMENT. Remember this word. Investment involves a careful consideration of cash flows and a firm's cost of capital. Malinvestment includes sinking money into anything investment bankers can bring public in the next six months. After you consider all the testimony about what has occurred in the U.S equity market in the past few years, you decide how to label the spending that has occurred, either investment or malinvestment.

While this may sound extreme, we have analyzed thousands of companies over the last 20 years, and never have we seen such a pattern of corporate recklessness as that of the last few years. Wall Street's lack of independence has contributed to this behavior in our opinion. How else to explain the many companies operating unprofitably for so long, while continuing to raise capital at will? Hundreds of companies have bought back stock at very high prices and taken on massive debt loads even while their business prospects deteriorate. Institutions entrusted with the task of raising needed capital for corporations traditionally have helped to restrain over-ambitious executives with uneconomic business plans. But we seem to be in environment where corporate recklessness is accepted or even encouraged. After all, mistakes are simply manifested in a multi-billion dollar accounting entry. How else can you explain the movie theatre business where six out of the nine leading companies have filed bankruptcy, with two others in dire straits.

We have already seen enormous misallocation of capital towards Internet and related companies, and we are now experiencing the slow-motion destruction of many of the telecom stocks. What's next?

The next bubble to burst
Our greatest fear is that this culture of growth with no regard to risk has permeated another critical part of the stock market and the economy -- financial stocks. Here again, Wall Street is virtually unanimous in their enthusiasm for the major players in this industry:

	# of buys	# of sells
Bank of America	18	2
JP Morgan Chase	21	1
Citigroup	22	1
Wells Fargo	21	1
Fannie Mae	19	0
Fed Home Loan	17	0
Goldman Sachs	9	0
Morgan Stanley DW	13	0
Merrill Lynch	13	0
MBNA	17	1
Capital One	21	4
Providian Fin	18	0

We are especially concerned about the financial companies because problems in this sector can ripple through out the entire economy. In fact, the rapid growth of companies in this industry, while often lifting the price of individual stocks, has created a historic credit bubble that threatens the economy. In September 1999, David W. Tice and Associates held a symposium entitled "The Credit Bubble and Its Aftermath" to express such concerns. Speakers included Lawrence Lindsey, Marc Faber, and Henry

Kaufman (Dr. Kaufman's presentation is included in Appendix D.) Since David Tice & Associates began managing, mutual fund money in 1996, we have extended our analysis from simply focusing on individual companies. We now have three analysts that look "*Behind the Numbers*" at global financial conditions, with a special emphasis on the imbalances created by rapid credit growth. Below is our summary of the current situation that, in our view, has been nourished by a climate of universal bullishness and aggressive expansion.

The U.S. Credit Bubble

It is our view that the U.S. is in the midst of an historic financial and economic bubble. Actually, evidence supporting this contention is unmistakable in data accumulated and disseminated by the Federal Reserve Board. After beginning the 1990's at less than $13 trillion, total outstanding credit market debt now approaches $28 trillion. Non-financial debt has expanded from $10.9 trillion to $18.4 trillion, while financial sector debt has surged from $2.6 trillion to $8.4 trillion. Most unfortunately, the greatest accumulation of debt in history runs unabated, with the first quarter experiencing record issuance of new debt securities. Concomitant with this credit bubble, the value of the U.S. equity market has surged by over $10 trillion to about $15 trillion. Combined, the value of outstanding equity and credit market instruments is approximately 400% of GDP. More than at any time in history, including the 1920s, it is very much a case of the financial markets driving the U.S. economy instead of the economy driving the markets.

This extraordinary period (1990 to present) has been marked by momentous changes in the financial system, both in the type and variety of institutions extending credit, as well as the myriad of securities and sophisticated instruments and vehicles available. This period has been marked by the rising dominance of Wall Street "structured finance," and any discussion of the integrity of equity analyst recommendations must be placed in the context of the analyst's role in supporting investment banking and security issuance. It is worth noting that of the more than $15 trillion increase in outstanding credit market debt over the past 11 years, less than $3 trillion has accumulated on the balance sheets of our nation's commercial banks. The tradition of the prudent banker extending loans to sound businesses, expecting to live with these lending decisions until maturity, is increasingly a thing of the past. It is critical to understand this development. The lender is today is now a security issuer with less concern about repayment. As a result, the hallmark of contemporary finance is the explosion of borrowing through the securities markets, and a proliferation of non-traditional financial institutions providing readily available credit for virtually any purpose. Too often, it is now left to the whims of the marketplace to determine what companies and industries are allocated financing.

Consumer finance

Nowhere has this momentous transformation of the financial architecture been so apparent – and credit made so readily available - as in real estate and consumer finance. Outstanding mortgage-backed securities have jumped almost 200% to $1.8 trillion. Asset-backed securities (credit card and auto receivables, home-equity loans, equipment leases, etc.) have increased almost four-fold to $1.8 trillion. It is simply not possible to overstate the dominant role Wall Street has come to possess in our nation's financial system, both in the enormous creation of securities and instruments and in managing what has been the corresponding ballooning of investor financial assets. Assets under mutual fund management have skyrocketed from about $600 billion at the beginning of 1990 to today's estimated $4.5 trillion. Money market funds have seen assets jump from $425 billion to over $2 trillion. Total assets held on the balance sheets of the securities broker/dealer community have increased from $262 billion to over $1.2 trillion.

Notably, Wall Street's expanding influence has been matched by the unprecedented lending and market (and political) power attained by the Washington-based Government Sponsored Enterprises (GSEs). Since 1990, total GSE assets have increased over 300% to $2 trillion. Fannie Mae began the 1990's with assets of about $125 billion and ended this year's first quarter with total assets of $701 billion. During this period, Freddie Mac assets increased from about $35 billion to almost $500 billion. In 11 years, outstanding agency securities (mortgage-backed securities and GSE company debt) increased more than 230% to $4.3 trillion, with much of this growth coming over the past three years. This stunning – and we would argue reckless - growth runs unabated, with Fannie Mae and Freddie Mac currently expanding lending at better than 20% annualized rates.

Since the global financial crisis that came to a head in the U.S. during the second half of 1998 (Long-Term Capital Management collapse), Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System have increased asset holdings by an astounding $766 billion. This unprecedented credit creation, in combination with extreme accommodation from the Federal Reserve, "reliquefied" the imbalanced and acutely vulnerable U.S. financial system. But it should be recognized that such aggressive market interventions come at a considerable cost, both emboldening the speculating community and creating the liquidity to fuel the next bubble. In the case of the 1998 intervention, the massive liquidity created by the GSEs played a critical role in fueling the Internet/telecommunications bubble. The bursting of this bubble is now quite problematic for the U.S. financial system. We may never know the costs associated with this most recent round of aggressive GSE "reliquefication" that began about nine months ago. At the minimum, this aggressive action is further inflating the dangerous real estate and consumer debt bubbles.

Market dynamics

While the bullish consensus would certainly disagree, the fact that the U.S. financial sector is now firmly locked in credit bubble dynamics is seemingly conspicuous in both the data and in market dynamics. Crisis leads only to another bout of Fed accommodation, wild credit and speculative excess, culminating in the next more problematic period of financial tumult. But then again, there is simply no way of curing the damaging consequences of credit and speculative excess with additional debt, and it should be clear that such a process only becomes more dangerous over time; we would actually argue that risk actually grows exponentially. Until this cycle is broken, there remains a clear and present danger of processes escalating uncontrollably to the point of potential financial collapse. The bottom line is that past borrowings were of unprecedented proportion, and at the same time were spent unwisely. We discuss this further in the CAPITAL MISALLOCATION section. Despite Wall Street propaganda espousing the "New Economy," please recognize that there is no historical precedent for an economy borrowing and consuming its way to sustained prosperity. The key to economic success is sound investment financed by savings. Unfortunately, past credit excesses fostered an environment of incredible profligacy where too many unprofitable (and hopelessly uneconomic) ventures received financing. It should be obvious that perpetuating such an environment poses great risk to both the U.S. economy and financial system.

An explosion of money and credit is, by definition, highly inflationary. After all, the excessive creation of new financial claims – or new credit – fuels over-spending and what should be recognized for its unmistakable inflationary effects. And while conventional analysis is fixated on consumer prices, we subscribe to a view of inflation posited by the "Austrian" school of economics. This view holds that credit excess creates inflationary manifestations through several distinct channels, with varying effects depending on particular circumstances. Obviously, additional credit-induced buying power may increase the prices of consumer goods and services – this is precisely what most contemporary observers recognize as "inflation." We would argue that while traditional inflation has not been overly problematic up to this point, surging energy prices provide strong warning of heightened general inflationary pressures not atypical for this late stage of a business cycle.

Financial inflation

Importantly, however, there are several other forms of destabilizing inflation that go unappreciated, despite the fact that they continue to be the major inflationary manifestations associated with this extraordinary boom. Excessive credit growth has created enormous additional purchasing power that has fueled an investment boom, with both over-investment and endemic malinvestment particularly prevalent throughout the Internet and telecommunications industries. The consequences are a misallocation of resources, wasted assets, a redistribution of wealth, and impaired financial assets. Furthermore, huge additional purchasing power has been directed at asset markets, fueling what should be appreciated as an historic asset bubble. Most now accept that NASDAQ developed into a bubble, but we would today argue that a much greater and more problematic bubble continues to inflate in real estate markets. And finally, additional credit-induced purchasing power can be directed at imported goods and lead to escalating trade deficits and a dangerous accumulation of foreign liabilities. Certainly, additional perceived wealth arising from the stock market and real estate bubbles have played an instrumental role in the consumer borrowing and spending binge. The collapse of household savings from what at the time was considered an insufficient rate of 8% during the first half of the 1990s to the recent dip into negative territory is an imbalance that must eventually be corrected. It has been quite a party, but accumulated debts must be serviced and eventually repaid. Importantly, in all cases credit excess fosters over-spending with detrimental effects to both the financial system and economy.

Ironically, consumer goods inflation is the least dangerous, as it is both conspicuous and easily rectified by aggressive action by the Federal Reserve. At the same time, asset inflation, distortions in the saving and investment process, and trade deficits are a much different story, with no constituency ready to support the difficult decision to fight these injurious but often surreptitious processes. It is, however, these very inflationary manifestations that are the most dangerous consequences of the current Wall Street and GSE-led financial bubble. Investment distortions, as are becoming increasingly conspicuous throughout the technology sector, can destroy profitability and create financial and economic instability. Trade deficits have significant negative economic effects, as well as creating problematic financial imbalances – as is clearly evident presently with current account deficits ballooning to about $450 billion annually. At the current rate of growth, the deficit could reach $800 billion by 2003. Such deficits are unsustainable, and this unprecedented accumulation of liabilities to foreigners is a bill that will someday come due.

For purposes of this testimony, it is worth highlighting asset inflation, a subject at the very heart of current financial sector vulnerability. First, it is important to appreciate that asset inflation is especially problematic for several reasons, including that it is incredibly seductive. Many incorrectly refer to rising equity and home prices as "wealth creation." Yet, true economic wealth is not created by additional credit entries on the electronic ledger that comprises the contemporary monetary system. Policymakers can also be seduced by asset inflation and the resulting surge in tax revenues and campaign contributions. Such inflation spawns dreams of perpetual government surpluses. As such, politicians and special interests are likely opposed to any central bank intervention aimed at the stock market. And can you imagine the Federal Reserve coming out and stating that they are aggressively raising rates to squelch rising home or stock prices? Obviously, that's not going to happen.

So it is vital that central banks nip asset inflation in the bud, because once it takes hold it's strictly "off limits." But central banks, as we have witnessed with the Federal Reserve, are quite prone to ignoring initial asset inflation, perhaps because they don't recognize it. Often, even top central bankers fall prey to manic notions of New Eras, New Paradigms and economic "miracles." And the longer asset inflation is accommodated – allowing asset inflation to forge a bubble economy - the greater is the structural impairment to the economy and financial system, and the more dangerous and difficult asset inflation is to control – as we've seen. Indeed, the Federal Reserve spent years attempting to determine if the U.S. was experiencing an asset bubble before Chairman Greenspan seemingly ended the debate by stating that it is impossible to know until after the fact. This is most unfortunate analysis.

Wildcat finance
The critical point today is to appreciate that Wall Street and the U.S. financial system have been left to their own devices, with the outcome being truly unprecedented credit and speculative excess – a historic period of "wildcat" finance. We will present specific examples of this reckless finance throughout this testimony. It is the proliferation of these excesses that have placed the economy in jeopardy. Credit excess begets only more excess, and financial bubble begets a precarious bubble economy. Especially with the collapse of the technology bubble, extreme accommodation by the Federal Reserve and liquidity from the GSEs are today only exacerbating an already dangerous bubble that has developed throughout real estate and consumer finance, as well as fostering general imbalances throughout the financial sector and U.S. economy. Over the past twelve months broad money supply has expanded by an unprecedented $840 billion, or 13%. The Bank of International Settlements recently reported that over-the-counter derivative positions now surpass $95 trillion. These and other extraordinary data are indicative of extreme financial distortions that we urge be addressed before it's too late. The unfolding California energy crisis and collapsing profits throughout the U.S. manufacturing sector are indicative of the severe structural distortions that have taken root throughout the U.S. economy. Most unfortunately, Wall Street and much of the U.S. financial sector continue to work aggressively to perpetuate this bubble, imparting only greater damage to the U.S. financial system and economy, as well as tremendous risk to its citizens.

For more on the Credit Bubble
For further discussion of the credit bubble we suggest readers consider the presentations made at our September 21, 1999 symposium "The Credit Bubble and Its Aftermath." Several audio clips are available on our web site at http://www.prudentbear.com/bearlibrary.htm. Also included in Appendix D is a transcript of the keynote address by Dr. Henry Kaufman (who has experience at the Federal Reserve and on Wall Street). He presents 12 brilliant ideas in his speech entitled "Lessons We Should Have Learned."

Lesson #8 was: "Investors cannot rely on the sell-side analysts to alert them to bad news. They also cannot rely on government, the IMF, or the World Bank staff either."

The other 11 lessons are well worth reading as well.

For more in-depth consideration of the credit bubble and its ramifications, we suggest reading two outstanding narratives written by Doug Noland, the Prudent Bear Fund market strategist. The first is a speech given at a Washington conference called "Toil and Trouble - Evaluating Quality of Earnings - and Risk - In the Financial Services Sector." The speech, "How Could Irving Fisher Have Been So Wrong?" is attached in Appendix F includes a discussion of the risks of derivatives. For a further discussion of the role played by the Government Sponsored Enterprises, please read Doug's article from "The International Economy," titled "The Great Experiment" found in Appendix G.

3. Capital misallocation

Do you wonder why our country does not have enough power plants and oil refineries, yet we have a reported 80-90% over capacity in fiber optic cable? There is a consequence to keeping stock prices artificially high for extended periods while extending credit recklessly in the midst of a mania. The overpriced sectors suck capital away from other vital areas of the economy. For years refinery stocks sold at low multiples of earnings and book value, and received comparatively little coverage for companies of their size. It is not surprising that companies in this industry were unable to increase capacity. As a nation, we are about to pay for this crucial misallocation of capital.

Fed Chairman Paul Volcker summed up this tragic misallocation best:

"The fate of the world economy is now totally dependent on the growth of the U.S. economy, which is dependent on the stock market, whose growth is dependent on about 50 stocks, half of which never reported any earnings"

While investing fads are to be expected in free markets, the coddling of companies by analysts fueled a massive over-investment in technology. This infatuation with all things high tech diverted capital from other sectors of the economy. In other words, while a mania for Internet and telecom stocks may have been inevitable, it should have been tempered by sober Wall Street research which would have included a cautionary word and a "sell" recommendation or two.

In a more discerning environment, we suspect that fewer companies could have transformed a flimsy business plan into an Initial Public Offering. Certainly IPOs have always been fraught with risk, but until the late '90s companies were typically viable, profit making enterprises by the time they went public. In fact, Amazon.com in 1997 was one of the of first companies with large losses to complete an IPO.

Instead, a uniformly bullish climate enabled investment bankers to bring 214 Internet companies public, raising $16.9 billion in 1999 alone (according to IPO Monitor), and along with that, an estimated $1 billion in underwriting fees.

With all these new Internet companies, individual investors were looking to Wall Street for help in identifying the winners. This need for guidance combined with the proliferation of business news programs seeking comments on individual stocks elevated the image and power of the Wall Street analyst. *Fortune* magazine (3/20/00) quotes Keith Benjamin, an ex-Internet analyst who said, "The analyst has now grown in stature from providing advice to institutions to being a beacon for *Fortune* or CNBC. It's dangerous because it's impossible to give the same amount of detail in context or tone to retail investors."

That is, institutional investors have learned to live with Wall Street's lack of objectivity, playing the game with a nod and a wink. And because money mangers had the ability to speak to analysts directly they could learn about risks that were not revealed in a published report. Retail investors, however, were left with a sea of buy recommendations and a series of 30-second interviews. Unfortunately, the naïve retail investor thought these analysts had their best interests in mind, not understanding that actual or potential investment banking relationships governed Wall Street recommendations.

Investors fed on this uniformly bullish environment. The voracious demand for IPOs in the secondary market further stimulated the IPO market, which in turn fed the venture capital market. Typically, venture capitalists make a number of long-term bets on the financial viability of innovative companies. But the Internet mania changed the role of the venture capitalist to a "cash out" specialist. Upstart companies no longer need to prove themselves viable, they just needed the right story. The traditional focus on cash flow changed to a focus on monetizing the story via IPO. In our view, this was the ultimate pyramid scheme, involving billions of dollars. The *Financial Times* (Dec. 5, 2000) notes that venture capital investments in Internet companies rose from $176 million in 1995 to $19.9 billion in 1999. In the five years ending Nov. 1990, IPOs by Internet companies plus venture capital investments and secondary offerings provided $150 billion to Internet companies alone. That's roughly the GDP of Norway.

VCs came to rely so heavily on the IPO market that according to *Forbes* (5/15/00), "within days, even hours, of NASDAQ's tumble, venture firms went on the defensive, slashing company valuations, freezing contracts with young private companies and backing out of deals altogether."

Clearly the Internet mania resulted in an enormous misallocation of capital, one that we believe was fostered by a uniformly bullish Wall Street. While investors had every right to fund Internet rather than energy companies, surely the boom and subsequent bust would have been less severe with a degree of analytical objectivity.

"Sell Now!"
Certainly there were analysts who understood the risks of investing in unproven Internet companies, but negative reports or sell recommendations were rare. Yet, off Wall Street, two editors of *Red Herring,* a magazine and web site for high tech investors, were skeptical of the stock market hype. In 1999, Anthony B. Perkins and Michael C. Perkins wrote "The Internet Bubble" (Harper Business) to argue that despite the promise of the Internet, making money in Internet stocks was far from a sure thing.

The authors compiled a list of 133 publicly traded Internet companies that they urged investors to "Sell Now!" Neither author has an investment background, yet both could see the chasm between Internet stock prices and reality. They quote Jim Breyer of Accel Partners (a venture capital firm), "It's emotion, it's frenzy, it's the fad, and 90 percent of the companies should never have gone public and will go out of business or hit very hard times."

The 133 Internet companies the authors reviewed in June 1999 boasted a combined market value of $410 billion on sales of only $15.2 billion. That means the companies were selling for more than 25 times sales when 25 times earnings typically has proven to be a rich valuation for IPOs. To justify the lofty valuation of their group of upstarts, the authors concluded the 133 companies *as a group* would have to increase revenues more than 80 percent a year for five years. By comparison, Microsoft's revenues rose 53% a year in the five years following its IPO. This conclusion is based on a number generous assumptions, including a price to earnings ratio of 40 times earnings five years from the date of the calculation, and reasonable net margins. The authors developed their model with help from investment bankers, analysts and venture capitalists. The book was published as the Internet boom was still in progress, warning investors to stay far, far away.

Buy or at least accumulate
While the editors of a business technology magazine were warning investors about the coming Internet crash, Wall Street was encouraging investors to buy, or at least "accumulate" Internet stocks.

For example, drkoop.com was one of the 133 stocks reviewed by the *Red Herring* editors, and by their calculations, was significantly overvalued. Bear Stearns, however, was not so bearish. In July 1999, the Wall Street firm (and underwriters of the company) published a report rating the stock a "buy." While the report did discuss risks including a "crowded consumer health care portal market," the report highlighted the company's "first mover advantage" and called the company "one of the most attractive vertical portal opportunities on the Internet." According to a table inside the report, the stock was selling for just over 30 times estimated sales for the year 2000. Losses were projected through at least 2001. Like many Internet companies, drkoop.com struggled financially, ultimately joining the many Internet stocks selling for less than $1.

In December 1999, Merrill Lynch rated a group of 16 Internet stocks "buy" or "accumulate." According to an Internet/E-Commerce report, the Merrill team's recommendations included Yahoo, Lycos, Priceline.com, Webvan, 24/7 Media, Ubid, Etoys and iVillage. The author of the report (Henry Blodget) did note the increasing competitive pressures in the "B2C industry," but his concern was a far cry from the "Internet Bubble" authors' admonishment to "Sell Now!"

The bullish bias on Wall Street led to widespread rationalization of the absurd valuations for Internet companies, helping to justify further misallocation of capital. In a January 1999, Credit Suisse First Boston published a report titled *Rational Exuberance? Is there method behind the madness in Internet stock valuations?* While the report did not purport to expressly defend the unprecedented valuations of the time, the report did want "…to offer some counterweight to the argument that current market values are completely unfounded." The report claimed, for example, that investors should be willing to pay more for Internet companies because of their modest capital needs. (Ironically, it was the drying up of external sources of capital that led to the demise of most Internet companies.) The report also used Amazon.com as an example of a company with a business model "…already more attractive than its competition," while noting that, "Those onlookers that refuse to look beyond the income statement are missing the substance of the model."

We think the *Red Herring* authors were closer to the mark. "Business fundamentals don't change," they argued. "A company's earnings are a function of the economic and social contributions it creates. Unless a company can demonstrate how it will create that sustained flow based upon its contribution, there is nothing to invest in."

Telecom bubble

It is our view that the virtual uniformity of "buy" recommendations on Wall Street not only fostered an Internet bubble, but it created the telecom bubble as well. Just as in the Internet mania, unproven telecom companies were funded based on wildly optimistic projections. Rather than objectively evaluating these rosy scenarios, Wall Street analysts fueled this euphoria with dozens of buy ratings, lofty "target prices" and wildly optimistic industry projections. The difference, however, was that while upstart Internet companies relied primarily on venture capital and equity financing, the "new era" in telecom also created hundreds of billions in debt. The ramifications of this debt build-up are just beginning.

According to a recent *Wall Street Journal* article (May 11, 2001) the $650 billion raised by telecom companies in recent years is proving to be one the biggest "financial fiascoes ever." The article, "Telecom Debt Debacle Could Lead to Losses of Historic Proportions" is in Appendix V. Losses to investors are estimated to approach the $150 billion government clean-up of the S&L crisis. Furthermore, the nature of telecom makes it difficult to salvage companies that fail. For example, because upstart telecom companies are typically unprofitable, their value as an acquisition is diminished. And because high tech gear is quickly outdated, the salvage value of their assets is greatly reduced. It's no wonder that earlier this year Bank One called telecom one of the problem areas in its portfolio.

Like the Internet bubble, ripples from the telecom problem reach from Wall Street to Main Street. According to *USA Today*, in the five months ending in April, telecom carriers and equipment makers fired more than 130,000 employees worldwide. Capital spending in 2001 is estimated to increase 2.1% compared to the whopping 34% increase last year. Managements are dealing with reduced revenue projections, but must continue to service the same amount of debt.

Certainly these companies should be accountable for their actions. But Wall Street can pressure management to make acquisitions, buy back stock, or expand. Not coincidentally, such activities require large amounts of new debt or equity securities. According to John Windhaussen, Jr., president of the Association for Local Telecommunications Services, "Wall Street analysts were telling our companies to build, build, build. We didn't worry about a return on investment."

According to Broadband Networking News, Glenn Waldorf, a telecom analyst at UBS Warburg agrees. "I think the current situation is partially Wall Street's creation," Mr. Waldorf said. "In its enthusiasm, Wall Street took approximately 35 CLECs public. However, there were not 35 strong management teams capable of running what is unquestionably an extremely difficult, complex business." Mark Langner, a telecom equity analyst at Epoch Partners Langnar agrees: "The capital markets have given everyone a false sense of security over the last four to five years."

Back in April, Windhaussen estimated that 100 carriers, or one-third of the total had failed since December. The *Wall Street Journal* article mentioned above notes that Wall Street firms made $7 billion in fees by raising debt and equity for companies since 1995.

The pervasive climate of bullishness on Wall Street is perhaps best illustrated by the sudden notoriety of Ravi Suria. Mr. Suria was a credit analyst at Lehman Brothers when he issued a report in mid-2000 critical of Amazon.com. While examining the company's convertible debt he concluded the securities were fraught with risk. The negative report thrust Mr. Suria into the spotlight. The obscure analyst's report drew scathing public rebuttals from Amazon's management. According to *Fortune* magazine (10/2/00), Lehman prevented Mr. Suria from debating Merrill's Henry Blodget on CNBC. Lehman also refused to publish a subsequent negative report. On June 26, Mr. Suria was the subject of a *Wall Street Journal* story.

Such was the notoriety attained by pointing out the obvious, that Amazon boasted poor operating fundamentals and a heavy debt load. To us, this is certainly testimony to the lack of independent thinking on Wall Street. The *Sunday Telegraph* (2/25/01) agrees, noting that "Even if Suria is wrong, his full frontal assault on Amazon has raised piercing questions about the cozy relationship between companies and the analyst community. Critics argue that many equity analysts have been slow to downgrade Internet companies. The litany of allegations includes lazy following of a company line and a conflict of interest since many of the companies are, or might be, potential investment banking clients."

It's difficult to believe a company with financials as shaky as Amazon.com was able to issue billions of dollars of debt and equity. Yet, Amazon is representative of how so much capital was diverted toward suspect enterprises. New technology was embraced by eager investors, whose enthusiasm was rarely tempered by objective analysis.

Under Allocation of Capital

We cannot stress enough that while Wall Street is aggressively seeking investment banking business in the technology and financial sectors, other important companies are ignored. We found nearly 1000 U.S. companies, each with more than $250 million in market capitalization, with fewer than three buy recommendations outstanding. Call the CEO of any of these companies and I doubt you will hear too many good things about Wall Street. Below is a sample of these companies, **real companies, in your districts** that are being hurt every day by Wall Street's gamesmanship. We believe the misallocation of capital associated with such gamesmanship harms the overall economy as well.

					# of Recommendations	
Ticker	Company	State	Congressman	Buy	Sell	Hold
CNL	Cleco Corporation	LA	Baker	2	0	1
SJM	J.M. Smucker	OH	Ney	0	0	2
CTB	Cooper Tire and Rubber	OH	Gillmor	2	0	4
CBIZ	Century Business Services, Inc	OH	LaTourette	0	0	1
OMX	Office Max	OH	Tubbs Jones	2	1	9
PYX	Playtex	CT	Shays	1	0	4
CUNO	Cuno, Inc	CT	Maloney	2	0	1
WTSLA	Wet Seal, Inc	CA	Cox	2	0	2
UGS	Unigraphics Solutions	CA	Royce	2	0	1
FLE	Fleetwood Enterprises	CA	Miller	2	1	1
GY	GenCorp, Inc	CA	Ose	0	0	1
DOL	Dole Food Co	CA	Sherman	1	0	0
SUG	Southern Union Co	TX	Paul	2	0	3
POWL	Powell Industries Inc	TX	Bentsen	1	0	0

CHX	Pilgrim's Pride Corp	TX	Sandlin	0	0	2
EE	El Paso Electric	TX	Hinojosa	0	0	1
TSO	Tesoro Petroleum Corporation	TX	Gonzalez	0	0	5
SKS	Saks, Inc	AL	Bachus	2	0	14
ISP	International Specialty Products	DE	Castle	0	0	1
OGE	OGE Energy Corp	OK	Lucas	1	0	5
GPC	Genuine Parts Co	GA	Barr	1	0	6
UFI	Unifi, Inc	NC	Jones	2	0	2
DL	Dial Corp	AZ	Shadegg	2	0	7
WSO	Watsco, Inc	FL	Weldon	2	0	1
PSS	Payless ShoeSource	KS	Ryun	1	0	5
SEB	Seaboard Corp	KS	Moore	0	0	0
INGR	Intergraph Corp	AL	Riley	1	0	0
VOL	Volt Information Sciences	NY	Fossella	0	0	0
VALU	Value Line, Inc	NY	Meek	0	0	0
OSG	Overseas Shipholding Group	NY	Crowley	2	0	0
GTIV	Gentiva Health Services	NY	Ackerman	1	0	0
TOPP	Topps	NY	Velazquez	2	0	1
GFF	Griffon Corporation	NY	Israel	1	0	0
FSS	Federal Signal Corp	IL	Biggert	2	1	1
CCC	Calgon Carbon Corp	PA	Mascara	2	0	1
JLG	JLG Industries Inc	PA	Kanjorski	2	0	3
KMT	Kennametal, Inc	PA	Hart	2	0	3
YRK	York International Corp.	PA	Toomey	2	0	1
BTGC	Bio-tech General	NJ	Ferguson	2	0	0
K	Kellogg, Inc	MI	Rogers	1	1	15
FLIR	FLIR Systems, Inc	OR	Hooley	1	0	0
H	Harcourt General, Inc	MA	Capuano	0	0	1
LFB	Longview Fibre Company	WA	Inslee	1	0	1
BKI	Buckeye Technologies	TN	Ford	2	0	2
TII	Thomas Industries Inc	KY	Lucas	1	0	0
CEM	Chemfirst Inc	MS	Shows	1	0	1
BEZ	Baldor Electric Co.	AR	Ross	2	0	2
Totals				**58**	**4**	**111**

4. Enhanced credibility for loose or "creative" accounting practices

It is our view that if analysts were truly independent of the companies they followed, they would demand and eventually receive better accounting practices and disclosure from the companies. Instead, analysts most often want to see favorable results to justify their buy recommendation. Most analysts love a company that hits its expected EPS number every quarter, even if they used every bit of creative accounting at their disposal to reach the number. Our all-too-flexible accounting rules make such machinations possible.

In a recent *Business Week* article, one portfolio manager said, "CEO's are obsessed with growth. They, as in the past, tortured accounting to produce income statements that would be applauded by Wall Street."

Three items make it particularly difficult to understand how profitable a company actual is.

1. Write-off accounting - Wall Street analysts actually cheer on companies to take large “one-time” charges to write down losses and set up significant reserve accounts. The analysts realize that it will be easier for the company to reach its future earnings target because of the existence of this large reserve. Despite the SEC's vigilance on this issue, there are still many borderline expenses that can be charged against these reserves. The constant flow of one-time charges (that sometimes occur almost every year) makes it very difficult to determine how fast a company is actually growing. Wall Street bankers want companies to spend aggressively. If they make a mistake, they can bury the costs in a charge without being penalized by analysts.

2. Stock options - Stock options are a very complex issue. We may never know how much compensation expense has been understated at companies where stock options (instead of cash) were used to pay employees. Throughout the Internet boom we saw very few analysts warn about the potential dilutive effect of stock options. At issue is the fact that accounting rules do not measure the true “economic cost” of stock options. Many of our concerns about stock options and current accounting standards for stock options can be found in a report included in Appendix H titled “Stock Options: Be Prepared for a Sea Change.”

3. Pro forma numbers - While this abuse has been around for years, the publication of pro forma numbers to remove the focus from the poor numbers reported under GAAP has dramatically increased in recent years. The SEC’s Chief Accountant calls pro forma results "EBS accounting"--for Everything but Bad Stuff. Far too often they seem to be used to distract investors from actual results. The use of pro forma numbers is another accounting trick that analysts should be upset about, but instead it has been embraced by Wall Street.

5. Safe haven for aggressive fund managers

One little-discussed effect is the problem caused by Wall Street's research being combined with a variety of "momentum" investment strategies. Momentum investors look for stocks with ever-rising chart patterns, having little regard for business fundamentals. In fact, some proclaim, “I don't care whether the valuation of the stock is 5x revenue, 10x revenue, even 100x revenue, if the chart looks good and the analysts plan to keep promoting the stock, I'll buy the stock.” It has become very easy for the fund manager to justify his investment by saying, "Sure it is expensive, but 19 of the 20 analysts are recommending “buy,” so it must be a decent stock to own.” We certainly believe in free markets, but when speculation is allowed to run out of control, due to a lack of integrity in the financial markets, and a tendency towards pyramid scheme type behavior (as discussed in the IPO scandal accusations), these investment methods can exacerbate the financial mania.

One illustration of the degree of risk investment managers are willing to take comes from analyzing the high valuation stocks held in their portfolios. Shown below are the average valuation statistics for 10 of the more popular growth-oriented mutual funds. Remember, these are average valuations for all of the stocks held by these funds:

P/E	Price/Book	Price/Sales
39.1	8.3	7.6

Together these funds control more than $170 billion in assets. The funds are so similar that when you compare how the funds have performed, they have correlation coefficients of 80% to 95%. Shown below are their ten most common holdings. Clearly the mangers are buying what Wall Street is recommending.

	# buys	#sells	#funds
Cisco Systems	32	3	10 of 10
General Electric	19	1	8 of 10
Pfizer	29	1	8 of 10
EMC	22	0	9 of 10
Microsoft	25	0	8 of 10
Sun Micro	20	1	9 of 10
AIG	18	0	7 of 10
American Online	33	2	7 of 10
BEA	29	1	8 of 10
Veritas	27	0	9 of 10

Potential Solutions

We do not pretend to be experts in the area of securities law and regulation. We present the following ideas in the spirit of general directions to take, not specific laws to change. Not included in our list of solutions are proposals that try to tinker with analyst compensation schemes or require some type of peer review. We believe the problems are so significant, and so critically important, that bold solutions, not incremental change, is required:

1. Separation of research from investment banking and trading
2. Requiring that Wall Street place a price tag on its research
3. Improvement of conflict disclosure on published reports
4. Tighter ethics rules and better analyst education
5. Move towards less-flexible accounting rules
6. Limit the use of stock options
7. Quadruple the SEC budget
8. Recommendation database
9. Investor education

1. Separation of research from investment banking and trading

The best solution to the problem would be to completely separate research from both investment banking and trading. Regulators should admit that the current "Chinese Wall" has too many holes to make enforcement of this policy possible. All of the conflicts cited in our first section certainly suggest the imaginary wall is not working. The potential profits for both the firm and the individual are just too great to expect compliance.

In practice, the complete separation of research from both banking and trading would require a significant change in Wall Street's business practices. It would amount to re-regulation in an era that has stressed deregulation. However, given the size and consequences of the problems we have presented, this solution is well worth considering. Even serious consideration of this re-regulation might force Wall Street to begin "cleaning up its act." However, extreme political courage would be necessary as the lobbying forces that would try to prevent this change would outweigh those arguing for the change by at least a factor of 100-to-1.

2. Requiring that Wall Street put a price tag on their research

Wall Street firms should be forced to put a specific price tag on their research. This potential solution is somewhat complex, but if complete separation is not feasible, it might be the best solution to the problem. To understand this solution it is first necessary to understand how Wall Street research is sold to institutional investors.

Portfolio managers too often see Wall Street research as "free goods." Portfolio managers need access to Wall Street's trading ability to get the best execution on their transactions, and also need access to IPOs, if this is part of their strategy. To gain this access, the managers must do business with the big brokerage firms. The research is bundled with trading and IPOs and the portfolio manger is expected to do an often unspecified amount of trading volume to continue receiving these services.

Generally, if a portfolio manager wants to buy independent research he must agree to a specific price and often sign off on an invoice. This subtle difference is a significant barrier to entry for many small independent research firms who would like to sell their research ideas to portfolio managers. If the large brokers had to put a specific price on their research service, free-market competition would be significantly enhanced. If you still find this brief explanation confusing, consider the following analogy:

A portfolio manager has two choices for lunch . He can either receive for free an artery-clogging triple cheeseburger (Wall Street research), or walk up 10 flights of stairs to buy a $20 garden salad (independent research). The manager knows the salad will be much better for him, but the cheeseburger will be prepared by the finest French chef, have the best sauces and garnishes, and in fact be served directly to him by the finest wait staff (institutional salesmen). It will be hard to resist. Competing with this free lunch is difficult for the salad vendor who cannot afford to deliver and must spread his fixed costs over the few customers who make the effort to visit him. As a result, his salad seems expensive.

This example is over-dramatized, but it helps to illustrate the enormous competitive disadvantage that independent research firms actually face. A few independent research firms (including ourselves) have been able to compete against these enormous odds, but dozens more analysts never seek to set up independent firms, because competing against firms that essentially give away their research is just too daunting a prospect.

Admittedly, the details of this plan would require careful consideration between lawmakers, regulators, and investment managers. It is the spirit of this idea that is valuable to consider. Regulators should ask, "What can we do to cause truly independent research to flourish?" rather than taking on the arduous task of enforcing more rules, level the playing field and make it easier for independent firms to compete.

Once again, if you try to legislate this change, be sure you have your extra-strength industrial ear plugs. The howling from the large brokers, who fear open competition in the research marketplace, will be extraordinarily loud.

3. Improvement of conflict disclosure on published reports

At a bare minimum Wall Street should be forced to significantly improve the disclosure of conflicts of interest on its written reports. Rather than bury the disclosure in a vague footnote that often reads like the fine print attached to a sweepstakes offer, we would suggest full front page, highlighted disclosure of some combination of:

1. Banking fees received
2. Banking service performed
3. Loans or other securities held
4. Proprietary trading desk positions

Additionally, whenever someone publishes the number of buy recommendation that a group of brokerage firms has on a particular company, a strongly worded disclosure should accompany the information. This would make many more individual investors aware of the numerous conflict of interest situations.

4. Analyst ethics and education

Another possible solution could be a tightening of the securities laws that would make the statements made by the analysts in our first section a violation of some federal law. When analysts can openly admit that buy recommendations can be "bought," the laws are not strong enough. It is difficult to know exactly where to draw the line. This is a question best left to those with more legal and regulatory experience than we posses.

The industry should admit that the self-regulatory aspect of the largest professional organization (The Association for Investment Management and Research, known as AIMR, which administers the Chartered Financial Analyst (CFA) exam for analysts) has failed. The organization, now seen as the "union card" for analysts, has attempted to enforce a code of ethics. One ethical standard is a very well-worded "reasonable basis" standard that should apply to most of the abuses we have noted. However, as a privately funded organization that lives in constant fear of being sued, enforcement of these standard is practically impossible. The organization usually waits until some court or other regulatory body has administered sanctions before its acts. This makes the effect of losing one's CFA charter minimal. In fairness to AIMR, most of the analysts we have cited in this report are not CFAs, but many of their supervisors are, and they have just as much responsibility as the analyst himself. If regulators feel AIMR is any way a guardian of the highest standard of ethical behavior, they are mistaken.

The AIMR should refocus on its educational effort. As the business has become more complex and international, AIMR has tried to force a variety of new subjects on those taking their exam. The result has been CFAs that know a little bit about a lot of subjects, but that are often unprepared to perform the basic tasks of an entry-level analyst. In short, the old standard for passing the exam, "Would you let this person manage your money?" has devolved into "Does this candidate know something about zero-premium put-spread collars, leptokurtosis, swaptions, and mental accounting?" We believe that AIMR should focus more on teaching basic valuation methods, a sense of market history, and most importantly how an analyst should reach an independent conclusion about a stock.

5. Less-flexible accounting rules

In a perfect world the analytical community would demand better disclosure and accounting practices from the companies they follow, but if we cannot change the structure of Wall Street, we should attempt to make accounting rules less flexible. These changes would cause considerable consternation among both accountants and companies. Accountants like the flexibility because on the one-hand they fear shareholder lawsuits, but on the other, they want to avoid the tough calls that would contradict management. The companies like the status quo because of the ease in which they can manage their quarterly earnings. The problem is that unpleasant news is often hidden until the fundamentals of their businesses are so weak reality can no longer be denied.

6. Limit the use of stock options

Twenty years ago it seemed that many corporate executives did not know the price of their stock. Today management seems to hang on every 1/4 of a point. We certainly encourage management to work for the long-term best interest of their shareholders, but stock options often are a great incentive for short-term management of the company. We’ve found that options can encourage managements to take more reckless actions to please Wall Street, with analysts then working diligently to keep stock prices levitated while company insiders liquidate holdings.

Ironically, rather than align the interests of shareholders and management, stock options often lead to divergent interests. If analysts were objective, investors would be alerted to the repercussions of short-term thinking. At a minimum, stock options should have a higher profile in financial statements rather than be limited to disclosure in footnotes. Options have a true economic cost and investors have a right to know that cost. We have included a report that our firm has produced on this topic in Appendix H.

7. Quadruple the SEC budget

While we hesitate to suggest that "hiring more policemen is the best way to fight crime," this may be the only solution. At the very least this could be used as the hammer. Put on the record that Congress stands ready to quadruple the SEC's budget (double the staff, and double their pay) if the problem is not solved in 12-24 months. This could be the best $2 billion our government ever spends. Ensuring fair play in capital markets where trillions of dollars are involved is an important matter.

We commend outgoing Chairman Levitt for his strong statements in the area of analyst conflict and strongly endorse his action on fair disclosure. He clearly seemed to understand the problem. The lack of action on analyst objectivity is frustrating, but perhaps reflects political realities. The staff is clearly overwhelmed monitoring 8,000 public companies and thousands of investment managers. New resources would have to be committed to improve the objectivity of Wall Street research.

8. Analyzing the analyst – develop a Recommendation Database

While investigating this subject in the preparation of our testimony we were presented with an interesting solution by Kei Kianpoor, the co-founder of Investars.com. Mr. Kianpoor suggests that all brokerage recommendations be reported to the SEC on a timely basis in electronic form. A database could be established so that anyone could analyze the performance of an individual analyst or firm. Standards have now been established to careful restrict how investment managers report performance to their clients, but there are no restrictions on trumpeting analysts' performance. Recommendation data is currently very difficult to collect, but under this proposal everyone would have access. We favor ideas that promote full disclosure.

9. Investor education

So many investors have learned about investing during a period of steadily rising markets that we must take great care to be sure they understand both risk and return. We would suggest three areas of emphasis.

1. Investors must learn they are buying a fractional share of an actual business, and not just a piece of paper to be traded like a baseball card.

2. Teach that every asset has a price at which it becomes overvalued and another price at which it becomes undervalued. Investing would be easy if all you had to do was choose the best company. Very few people would walk into an auto showroom and buy a car without asking its price, almost no one asks about the price (valuation, not the commission) before buying a mutual fund.

3. Teach Americans that investing is both a right, and a responsibility, just like voting. No single investment will damage the financial system. No single vote will damage the political system. However, in total, societies that either invest or vote, without proper care, are destined to suffer unpleasant consequences.

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