House Committee on Financial Services
31 July 01

Good morning Mr. Chairman my name is Charles L. Hill. I would like to thank Congressman Baker and members of the committee to let me give my views on this important issue.

Let me first mention the usual disclaimers. The views expressed here today are my personal ones and are not necessarily those of my employer, Thomson Financial / First Call, where I am director of financial research, or those of the Boston Society of Security Analysts, where I am a vice president and a director. I am a Chartered Financial Analyst and proud of it. My only aim today is to uphold and improve on the quality and the integrity of my profession.

The problems we are talking about today are not new. They tend to wax and wane with each stock market cycle. The only difference this time is that some of the problems may be worse than in past cycles. There do seem to be some secular trends underway that may have been exacerbated by the cyclical swing in the market, and that need to be corrected. Any prolonged corrections in stock prices tend to wring out some of the excesses we are talking about today. Nevertheless, some of the underlying secular trends are disturbing and it may take more than just a market correction to remedy the situation.

Let me point out that in this market downturn, as in past ones, investors always look for scapegoats. The broker analysts are always an easy target. There is no doubt some basis for this, but it is most probably overdone. Let the record show that even at the time of the market's frothiest peaks, there were many broker analysts doing very thorough and objective research. The problem was that there were not enough in this category. There were too many whose work was shoddy and/or biased because of naivete, laziness, or outside pressures.

But let's not paint all the analysts with the same brush. As a former sell side analyst for 18 years, I shudder at the thought of returning to that field and having to compete with the top analysts of today. With all the technology tools available today, there is no question in my mind that today's stock research from the top sell side analysts is better than that from the top analysts of 25 years ago. What we need to improve is the quality and objectivity of the work from the rest of today's sell side analysts that are not currently doing their job as well as they should.

Before we turn to the causes of deteriorating stock research quality, it is worth looking at how the problems of quality and bias can manifest themselves. There are four data items by which analysts can distort an investors perceptions of a company's stock, or leave the investor confused.

1. Recommendations

2. Target Prices
3. Earnings Estimates
4. Earnings Basis

1. Recommendations

This sub-committee has previously raised this issue and has cited our data. The rough rule of thumb is that about one-third of all broker recommendations are in the most positive category (strong buy or whatever the broker's equivalent term is), about one-third are in the second most positive category (buy or whatever the broker's equivalent term is), about one-third are in the third most positive category (hold or the equivalent), while only about 1% are in the two bottom categories (sell and strong sell or their equivalents).

The individual investor needs a decoder that would put all the brokers' various terminology for their recommendations on a common scale. The brokers are doing a better job of putting in each research report a definition of what their recommendation terminology means, making it easier for investors to compare one broker's recommendation with another. However, not all are doing this. A better answer might be if the brokers could agree on a common scale with common terminology.

Unfortunately, the investor needs a second level on their decoder to adjust for the over optimism of the broker analyst recommendations. Since the better companies get more analyst coverage then do the weaker companies, there is a justification for somewhat of a positive bias to the recommendations. As of the end of July, 27.6% and 36.9% of the recommendations were in the "strong buy" and "buy" categories, respectively. Only 1.1% and 0.4% were in the "sell" and "strong sell" categories, respectively. That means the number of buys of all kinds were 47 times the number of sells of all kind. That much of a positive bias is hard to justify.

Last year, when the market was at peak levels, and many stocks were substantially overvalued, the ratio was even worse. On 1 March it was 92:1. On 1 May it was 100:1. As the market began falling, the ratio was still a very high 99:1 on 1 August. By 1 October it was 78:1. And today it is 47:1. It is a bit hard to understand why the recommendations were even more positively biased than normal at the market peak.

2. Target Prices

Target prices are another area where the analyst has the opportunity to put their naivete or biases to work. Target prices became the rage in the late 1990's but their popularity seems to have abated slightly. Many were unrealistic, but many of the analysts that were providing those have lost considerable credibility.

3. Earnings Estimates

Most analysts most of the time tend to start out too high with their estimates as the earnings report time for that period draws closer. On average the analysts take the estimates too far near the end of the period. More than half the companies in the S&P500 beat the final estimates every quarter. Whether the analysts have been misled by the companies guidance, and whether they knowingly went along with that guidance is debatable, but there does seem to be a too regular pattern of companies beating the estimates, particularly at some companies.

4. Earnings basis

One of the problem areas that is mushrooming as a problem, but is often overlooked is the determination of the earnings basis used to value the stock. The SEC requires companies to report earnings on the basis of Generally Accepted Accounting Principles (GAAP). Most everyone would agree that those numbers often need to be adjusted to exclude non-recurring or non-operating earnings. The problem is what one person considers non-recurring or non-operating another may not. There is no "right" answer. It is all in the eyes of the beholder.

A big part of the analyst job is to determine the appropriate basis for earnings as used in the price/earnings ratio or other earnings based valuation yardsticks. A companies earnings can often be enhanced by excluding items that normally would not be or by including items that would normally be excluded. The excesses in this area have been most common in the technology sector, where the use of the "cash earnings" or "proforma earnings" have taken on a wide variety of special meanings that have greatly enhanced some companies earnings.

There is a growing trend for companies to put out releases that emphasize an earnings number that has been adjusted to a basis the company espouses, sometimes to the almost total exclusion of the GAAP results. While companies should have the right to present earnings on a basis of their choosing in addition to the GAAP numbers, there should be ample quantification and discussion of the unusual items the company believes should or should not be excluded or included. The company release should provide the investor with the tools to adjust the results to a basis the investor believes appropriate.

Whether the companies do this appropriately or not, it is still a big part of the analyst job to examine the information and decide what is legitimately included or excluded. Today, too many analysts are being spoon fed by the companies to go along with many in the investment community would consider inappropriate if more time had been spent on the determination and/or if the time had been spent more objectively.

The analysts are the ultimate gatekeepers on keeping the companies from gilding the lily by espousing a basis that is out of step with normal practices. Not every restructuring charge or investment gain or inventory writedown is the same so some leeway is necessary in deciding what should be excluded or included, but based on recent practices it seems the analyst need to be more discerning and/or more objective.

These are four places in their reports that analysts can mislead investors. They can do so in any of these areas by either not doing thorough enough research, by not exercising good judgment, or by not being completely objective. The cyclical downturn will hopefully weed out some of the analyst with the first two failings, but will do little about the objectivity issue.

Analyst objectivity is subject to pressure from four different places.

1. The Analysts Themselves
2. Investment Banking
3. Public Companies
4. Institutional Shareholders

1. The Analysts Themselves

It may seem odd to list the analysts themselves as one of the factors affecting analyst objectivity. This bias may be conscious or subconcious. For whatever reason, most analysts have fallen in love with the industry they cover (otherwise most that had not would have moved on to another industry that was more favorable in their eyes). Secondly, they have selected as their coverage list what they consider the best companies within their industry.

As a result, the analysts come to the table looking through rose colored glasses. Their optimism can be characterized as an honest bias, but on that, nevertheless, colors their thinking.

2. Investment Banking

The pressure from the investment banking side of an analyst’s firm is the one that gets all the publicity. It is an easy one to make a good media story about. But let’s not be too hasty to blame the brokers.

In the days when I was a sell side analyst (1970 to 1988), the monetary incentives for analysts were directed at how good their research was. The institutions directed certain percentages of their commission business to specified brokers in return for research services provided by those brokers. Letters were sent each quarter to the brokers saying how much of their commission business had been directed to those brokers for research and listing the analysts who were the most valuable to the institution sending the letter. The analysts named most frequently usually got the biggest share of the research department bonus, and most, if not all, of that bonus pool came from the commission business research produced. Any remuneration for investment banking work by the analyst might have added a little sweetener to the pot. It was the frosting on the cake. Today it is the cake in many cases.

But in those days the incentives were such that the analyst were able to be objective and were able to devote most of their research time to fundamental research on their industry rather than chasing investment banking deals.

But the buy side institutions need to look in the mirror. It is the old story. You get what you pay for. With commission rates driven to almost nil, and with a greater premium put on trading execution, the institutions are paying for research to the extent they once did. Therefore, the brokers have had to look elsewhere to find a way to compensate the analysts, which inevitably led to the investment banking side of the house. Until the brokers again get reasonable compensation for their research product, so analysts can again be compensated primarily by research, it will be difficult to restore the so-called Chinese Wall of old between research and investment banking.

3. Public Companies

The investment banking arms of some of the brokers are not alone in putting pressure on analysts to say only nice things about a company. Some of the companies themselves do the same. Again, compensation is the issue. Some managements have significant cash bonus or options tied to stock performance. There have been occasions when companies have threatened to cut analysts off from communications with the company if they do not toe the company line. The SEC’s new Regulation FD does now provide some limited protection for the analyst.

4. Institutional Shareholders

Even the institution shareholders can wield some clout by making it difficult for analysts who put out research reports that cause any stocks the institution owns to decline in price while they are still major holders.

With all the pressures an analyst faces today that impact their research time and their objectivity, is not as easy to do as thorough and objective research as it was in the past. Let’s not blame the broker analysts for all of the problems. It is important to look at the underlying causes and find ways to remove the pressures that are causing the problems. It is to easy to expect the broker analysts will be able to solve the problems on their own. It is up to all the interested parties to understand the underlying causes and sit down together to try and solve them. It is in the best interest of all parties.