Forward Observer

James Glassman

Bulls, Bears, and Scapegoats on Wall Street

Every bear market needs a scapegoat, and congressional fingers are currently pointing at stock analysts. These are the professionals at investment firms who scrutinize financial statements, make on-site visits to companies, interview managers, query competitors, and then publicly render their opinions (buy, sell, or hold) on individual stocks. Most analysts have a specialty: utilities, semiconductors, airlines. As a financial columnist, I have had hundreds of discussions with analysts, and, in general, have found them quite knowledgeable.

But don't take my word for it. In April, an extensive study of the performance of analysts was published in *The Journal of Finance*, a highly regarded publication for scholars. The authors—Brad Barber of the University of California at Davis, Reuven Lehavy and Brett Trueman of Berkeley, and Maureen McNichols of Stanford—looked at a database of 360,000 pieces of advice from 269 brokerage houses and 4,340 analysts, released between 1986 and 1996. They found that the analysts' favorite stocks returned an annual average of 18.8 percent, while those that the analysts denigrated returned an annual average of just 5.8 percent. The Standard & Poor's 500 stock-market benchmark over this period returned an average of 14.5 percent.

These results are exceptional. Rare is the mutual fund that can beat the S&P 500 by four points over ten years. In fact, the benchmark has beaten a majority of funds over the past two decades.

In an unpublished follow-up a month later, the authors found, again, that analysts produced spectacular results between 1997 and 1999. But the year 2000 was a debacle. The highly recommended stocks did poorly and the least-favored stocks did well. What happened? Dr. Barber calls the year "a mystery," with a performance completely at odds with that of the previous 13 years.

Rep. Richard Baker (R-LA), chairman of the subcommittee with jurisdiction over the regulation of investment firms, seized on the 2000 results as the basis for a June 14 hearing on "whether securities analysts are providing unbiased research to investors." The unstated premise was that analysts were not objective—because they are torn by allegiances to the investment banking side of their firms (which earn big bucks by helping companies raise investment money), and by their own financial holdings.

During the bull market in tech stocks, many well-known Wall Street analysts, including Mary Meeker of Morgan Stanley Dean Witter and Henry Blodgett of Merrill Lynch, helped attract new business for their firms' investment bankers. No doubt about it. And Meeker, Blodgett and others were slow to change their optimistic recommendations for e-commerce companies like Priceline.com, so some observers wonder if their views were biased.

Peter Elkin of *Fortune* wrote that Ms. Meeker was "the single most powerful symbol of how Wall Street can lead investors astray," and that she "came to see herself not merely as an analyst but as a player—a power broker, a dealmaker, a force to be reckoned with." It is just this conflict—an erosion of the famous "Chinese Wall" separating the investment-banking side of a large Wall Street firm from the research side—which, in the eyes of critics, threatens the objectivity of analysts and the wealth of investors.

The truth is, conflicts of interest pervade the securities industry, because they pervade life. But the public can easily judge whether the professionalism of analysts overcomes their interest conflicts: If an analyst is biased, his recommendations are unlikely to beat the benchmarks. Investing is a tough racket, and anyone who judges stocks on criteria other than fundamentals and technical indicators will ultimately fail, and his track record—closely watched by journalists and professional tracking services—will soon cost him his job.

The real question is not whether analysts are torn by conflicts but whether government should enact regulations to try to remedy the situation. Government rules would often be unenforceable. And, at worst, they could restrict the flow of information by raising compliance costs and driving good analysts out of the business. Instead of advising the public, the stars would simply run their own accounts.

Investment firms have gigantic incentives to make sure analysts give objective recommendations. Biased analysts will give their firms a reputation for inaccuracy and corruption, and will lose customers. Why, then, haven't more firms taken steps to enforce and publicize Chinese Wall rules? Probably because investors don't really care about possible bias. They care about good advice.

Still, in anticipation of the June 14 hearings, the Securities Industry Association issued new "best practices" rules for 14 major firms. A few days after the hearing, Merrill Lynch issued its own new set of rules, tougher than the SIA's. These were both admirable steps, and if investors truly care about the issue, we will see other firms competing with Merrill to issue more and more stringent rules to ensure objectivity.

What bothered me about the congres-

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Energy Crunch Replay

What a difference a quarter century—and a President—makes

By Karina Rollins

"I want to have an unpleasant talk with you about a problem that is unprecedented in our history." Relax—that was Jimmy Carter, 24 years ago. The energy talk we're going to have today is far more pleasant and optimistic, about a problem that is no longer unprecedented.

In the early '70s, Americans lined up for gasoline the way Eastern Bloc citizens stood in line for toilet paper. OPEC imposed an oil embargo against the U.S. and Americans faced their first modern energy shortage. OPEC ended its embargo in 1974, but government controls on the production and pricing of oil and gas brought another painful squeeze in 1976-77. Ronald Reagan helped ease costs through deregulation of energy prices in 1981. New exploration plus efficient conservation—both kicked off by market pricing signals—restored the ample flow of moderately priced energy to America's active population.

Then, seemingly out of the blue: The price of natural gas more than doubled last year. Northerners saw their heating bills leap upward. Gasoline approached the $2 per gallon mark across the country. And people throughout California (and some other places) grew unsure whether their alarm clocks, stoves, and traffic lights would turn on in the morning. So bad has the situation in the Golden State been, with the constant threat of renewed blackouts and brownouts, that authorities have been worried about riots and serious damage to the state's business economy.

How did today's energy woes develop? As Charli Coon, an energy analyst at the Heritage Foundation explains, "Since 1973, U.S. energy consumption has increased by about 30 percent—roughly the same as our population growth. Simply put, there are more people using energy to power their homes, cars, air conditioners, televisions, and computers. But the number of

Karina Rollins is a TAE *senior editor.*

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