

Wall Street Research: Will New Rules Change Its Usefulness?

Leslie Boni and Kent L. Womack

To have missed the controversies surrounding Wall Street analysts in the past few years, one would almost surely have to be a modern-day Rip Van Winkle. Investors, politicians, regulators, and virtually everyone with an opinion has chimed in with criticisms, complaints, and anecdotes about analysts' conflicts and misjudgments. And not without cause. Clearly, two decades of ebullient bull markets leading up to the year 2000 highs created "opportunities" for sell-side analysts and their firms to engage in questionable and objectionable behavior.¹

The clamor about analysts has indeed resulted in change. The questions are: Will the recent efforts by politicians, regulators, and Wall Street firms to "fix" sell-side research make investors better off in the long run? What value does Wall Street research have for investors, and how will that value change in the future? Have the new rules and settlements gone too far or not far enough?

Background

Motivated largely by retail investors' complaints in the wake of plummeting stock prices, the U.S. Congress held hearings, titled "Analyzing the Analysts," in the summer of 2001. In May 2002, following the release of e-mails suggesting that some Merrill Lynch and Company analysts may have internally trashed stocks that were being publicly touted to investors, Merrill Lynch agreed in a \$100 million settlement with the state of New York to make changes in the monitoring and compensation of its analysts. By the summer of 2002, the U.S. SEC had approved new NASD and NYSE rules for sell-side analysts.² These rules mandate separation of research and investment banking and prohibit the compensation of analysts from specific investment banking deals. They also prohibit the managers of the company covered in an analyst's research

report from reviewing, approving, or changing the sell-side analyst's final research summary, rating, or price target. The rules prohibit banks from offering favorable research to companies in exchange for investment banking business or other compensation. The rules also require increased disclosures in a number of areas, including the analyst's personal trading positions and the historical performance of the analyst's recommendations for the company covered.

In addition, on 20 December 2002, the SEC, New York Attorney General Eliot Spitzer, the North American Securities Administrators Association, the NYSE, and the NASD announced that a \$1.4 billion "global research settlement" had been reached with the largest U.S. investment firms to "resolve issues of conflict of interest" and "bring about balanced reform in the industry and bolster the integrity of equity research."³ The settlement's provisions include fines and funds for customer restitution and investor education, funding and linking of independent research to brokerage research sites, supposed elimination of investment banking ties from analyst compensation, and discontinuation of the practice of having analysts participate in road shows and predeal evaluations in the capital-raising process.

Perspectives on Research Value

Of course, given the potential conflicts of interest that sell-side analysts face, readers might well ask whether analyst recommendations offer any value at all for investors. Academic theory has long suggested that the recommendations are of little value for investors if markets are reasonably efficient. Stickel (1995) and Womack (1996) documented, however, that upgraded stocks outperform and downgraded stocks underperform risk-adjusted benchmarks for one to six months following analysts' changes in recommendations. Barber, Lehavy, McNichols, and Trueman (2001, 2003) found excess returns from portfolios constructed by using strategies based on levels of analyst rating consensus but noted that these returns might not exceed transaction costs. Jegadeesh, Kim, Krische,

Leslie Boni is an assistant professor at the University of New Mexico, Albuquerque. Kent L. Womack is an associate professor at the Tuck School of Business at Dartmouth College, Hanover, New Hampshire.

and Lee (forthcoming 2003) found that quarterly changes in analyst consensus recommendations offer implementable trading strategies. Most academic researchers would agree, however, that the risk-adjusted returns from these strategies are statistically significant but, after typical transaction costs, economically modest.

On the one hand, retail investors' complaints that analysts did not get them out of stocks, especially technology stocks, as prices fell from their year 2000 highs were the motivation, at least in part, for the Congressional hearings, the rule changes, and the so-called global research settlement. On the other hand, some institutional investors indicate in surveys that they continue to value sell-side research (for example, see Boni and Womack 2002 and Ascarelli 2002). Why do retail and institutional investors have such differing perspectives on sell-side analysts?

The difference comes from the different expectations retail investors and professional investors have for analyst recommendations. We recently analyzed Thomson Financial/First Call I/B/E/S data consisting of 151,667 recommendations for U.S. stocks for the period January 1996 through June 2001.⁴ Although the nomenclature and number of rating or recommendation levels vary among brokerage firms, I/B/E/S partitions each brokerage recommendation into one of five categories—strong buy, buy, hold, underperform, and sell.

Recommendations in the I/B/E/S data we used were from more than 400 brokerages (including subsidiaries) and for about 8,000 companies. Approximately half the recommendations were from the largest 25 brokerage firms, all of which also provide investment banking services to corporate clients to some degree. We partitioned the stocks into 59 industries based on the Global Industry Classification Standard (GICS) of Standard & Poor's and Morgan Stanley Capital International.

Consistent with criticisms that analysts make too many buy recommendations and not enough sell recommendations, we found that strong buy and buy recommendations made up 67 percent of all recommendations and greatly outnumbered the underperform and sell recommendations, which constituted only 3 percent of the total. In fact, the consensus level of recommendations, averaged across all stocks, for the entire 5 1/2-year time frame was steadily a buy, the second-best level. Analysts' changes in recommendations were almost evenly split between upgrades and downgrades.

The important distinction between the *level* of a recommendation and the *direction of change* relative to the analyst's previous recommendation sug-

gests the first difference in how retail and institutional investors are likely to view sell-side analysts' output. Prior to the much publicized scrutiny of analysts over the past few years, many retail investors clearly did not fully understand the various conflicts of interest that can positively bias the level of an analyst's recommendation. Institutional investors, however, have long known that analysts may feel pressure, for a variety of reasons, to make their recommendation a buy. Yet, institutional investors also have known that the use of upgrades and downgrades enables analysts to signal their forecasts of relatively over- and undervalued stocks. Therefore, whereas naive retail investors may be influenced to purchase by the average level of a recommendation—buy or strong buy—institutional investors (if influenced by recommendations at all) are more likely to monitor the direction of change in recommendations.

Perhaps more importantly, institutional investors recognize that analysts typically cover stocks within a single industry and have incentives, such as reputation and the annual *Institutional Investor* All-America rankings, to be experts in the industry they cover. Therefore, analyst upgrades and downgrades are likely to signal important changes in information about a company's future. Surveys of institutional investors indicate that, although they may place little weight on the recommendations of analysts, they often read analysts' detailed research reports and want to hear new information or insights the analysts have obtained from their discussions with corporate managers, suppliers, customers, or regulators of the companies they cover.

Not only are institutional investors much more likely than retail investors to appreciate the distinction between recommendation levels and changes in the direction of a recommendation, but they are also much more likely to have an appreciation for the extent to which the information driving a changed recommendation is already known in the market.

As a result of the different perspectives, two questions are of interest. In connection with the perspective of retail investors, how valuable are the levels of recommendations? And in connection with the perspective of institutional investors, how valuable are the changes in direction of recommendations? **Table 1** shows the results for the levels of buy and strong buy recommendations from 1996 through the first half of 2001. If investors had followed a strategy of buying an equally weighted portfolio of all stocks with a consensus level of buy or better (rebalancing their portfolios at the beginning of each month for then current levels), their annualized return would have been 14.8 percent.

Table 1. Returns to Buy or Strong Buy Stocks, 1996–Q2 2001 and Subperiods

Period/Statistic	Invest if Consensus Level Buy or Better		
	S&P 500 Index Fund	All Stocks	Tech Stocks
<i>Entire sample period (January 1996–Q2 2001)</i>			
Annualized return	11.9%	14.8%	17.8%
Monthly Sharpe ratio	0.12	0.12	0.08
<i>1996–Q1 2000</i>			
Annualized return	20.2%	18.5%	35.3%
Monthly Sharpe ratio	0.27	0.19	0.24
<i>Q2 2000–Q2 2001</i>			
Annualized return	-16.5%	2.3%	-41.6%
Monthly Sharpe ratio	-0.35	-0.03	-0.21

For a rough comparison, Table 1 shows that this return is about 3 percentage points better than the annualized return from investing in an S&P 500 Index fund. The return for risk over the entire time frame, as measured by a monthly Sharpe ratio (return in excess of the U.S. T-bill rate divided by standard deviation of return), was about equal for the consensus level strategy and the S&P 500 fund strategy. Interestingly, the consensus level strategy underperformed the index during the market run-up (1996 through the first quarter of 2000) but outperformed it after the market highs (the second quarter of 2000 through the second quarter of 2001).

How about the highly touted tech stocks? What if an investor had bought only those stocks with a buy or strong buy recommendation that fell within one of the 10 GICS technology industries? As the last column of Table 1 shows, this “tech-only” strategy outperformed the S&P 500 fund during the premarket highs but lost heavily afterward. This result corroborates investors’ complaints that analysts did not anticipate the bursting of the tech bubble.

Now consider a strategy more in line with how institutional investors are likely to use analyst recommendations. To measure this perspective on the value of analyst recommendations, we calculated the one-month holding-period returns from a self-financing strategy of buying all “net upgraded” stocks and selling short all “net downgraded” stocks (a “net-net strategy”). A stock was considered net upgraded (net downgraded) if it received more upgrades than downgrades (more downgrades than upgrades) from all analysts in the previous calendar month.

As shown in Table 2, this strategy beat the S&P 500 fund for the overall time frame and during the period after the market highs. Perhaps even more

Table 2. Returns to Net Upgrade–Net Downgrade Strategy, 1996–Q2 2001 and Subperiods

Period/Statistic	Long Net Upgrades and Short Net Downgrades		
	S&P 500 Index Fund	All Stocks	Tech Stocks
<i>Entire sample period (January 1996–Q2 2001)</i>			
Annualized return	11.9%	16.6%	19.5%
Monthly Sharpe ratio	0.12	0.57	0.26
<i>1996–Q1 2000</i>			
Annualized return	20.2%	16.0%	18.6%
Monthly Sharpe ratio	0.27	0.62	0.29
<i>Q2 2000–Q2 2001</i>			
Annualized return	-16.5%	18.3%	22.6%
Monthly Sharpe ratio	-0.35	0.48	0.21

interesting is that this simple self-financing net-net strategy had a much better monthly Sharpe ratio than did the S&P 500 fund. Moreover, the strategy performed well even when restricted to technology industries. Finally, a comparison of Table 1 with Table 2 shows that the net-net strategy beat the consensus level strategy for the full period and the period after the market highs but not in the 1996–Q1 2000 period.

This comparison of how retail and institutional investors’ perspectives on and use of analyst recommendations probably differ shows that, despite the fact that buy and strong buy recommendations greatly outnumber underperform and sell recommendations, analysts are industry experts and, on average, can and do distinguish future winners from losers through upgrading and downgrading. And interestingly, even as the prices of tech stocks plummeted in 2000 and 2001 and a strategy of buying only tech stocks with a consensus level of buy or better performed miserably, tech-stock analysts were able to rank and signal future winners relative to future losers.

Effects of Rule Changes and Settlements

How will the rule changes and negotiated settlements affect sell-side research in the future? Many of the new requirements, such as those that attempt to provide for greater separation of sell-side research from the influences of investment banking, are clearly an attempt to disclose and potentially remove biases associated with the capital-raising pressures on analysts. Other changes emphasize educating retail investors, apparently in an attempt to provide them with a greater appreciation of the

"noisy" value of sell-side research that has long been appreciated by institutional investors.

Questions abound, however, as to whether various provisions have gone too far or not far enough. Will investors be better off in the long run because of these changes? Will retail investors continue to be at a severe disadvantage relative to institutional investors if they try to use the recommendations of analysts? Increased disclosure of issues surrounding conflicts is almost surely good for the transparency of markets and the confidence of investors. Nevertheless, let us play the devil's advocate on some issues that will remain problematic.⁵

A bundled service, such as investment research, which is usually paid for through trading commissions, is not really a free good. Investment banks spend hundreds of millions of dollars a year providing a research product for which they expect a return. In our surveys of market professionals (Boni and Womack 2002), we found that most market participants we questioned recognize that trading commissions alone do not pay for the amount of research "consumed," at least the amount investors have come to expect. Are professional investors really willing to pay a higher price if the cost of research is unbundled from other income of the investment firm?

Although potentially serious conflicts of interest certainly exist when investment banking revenues are used to help fund brokerage research, other problems are almost surely introduced when brokerage commissions must cover the entire cost of research. The fallout from unbundling research and investment banking is already showing up in the market. Brokerage firms have announced cuts in their research departments, reductions in the number of staff analysts, and discontinuations of coverage of some companies and industries. On the one hand, our research shows that when the number of analysts covering a stock or industry decreases, the speed with which new information is incorporated in market prices also decreases. In such a case, the remaining individual changes in recommendations become even more valuable than previously. So, ironically, just as retail investors are becoming "educated" to the potential conflicts of interest in sell-side research, changes in recommendations, as the number of analysts falls, are likely to offer more value to investors. On the other hand, more companies, because they are no longer covered by brokerage firm analysts, are likely to have to purchase PR-type "research coverage," which is unlikely to produce unbiased reports. In fact, to pay for the real costs of research (unsubsidized by investment banking), brokerage firms may try to increase the trading activity of

investor clients in the stocks and industries they do continue to cover.

The new requirements *imply* that independent research (brokerage research without investment banking ties) is better for investors. But why independent analysts will be less vulnerable than brokerage firm analysts to the same pressures for optimism is unclear. Analysts themselves have remarked that one source of strong pressure for "optimism biases" in recommendations is the need to keep access to the managers of the companies they cover; in other words, issue positive research or expect to be cut off from management guidance. Unfortunately, the Sarbanes-Oxley bill, which mandated many improvements in corporate managers' financial practices, did nothing to reduce the unethical practice by many managers of communicating only with those analysts who "cooperate" with management's implicit (and usually positive) forecasts of the future.⁶ Finding a way to fix this blind spot may be more important than all the other "sticks" regulating analysts combined.

Interestingly, Smith reported in the *Wall Street Journal* in April 2003 that after reviewing disclosure reports issued as a result of the new requirements, he concluded that the brokerage firms of the top investment banks are still more likely to give optimistic research recommendations to their own banking clients. Of course, the new disclosure requirements attempt to protect investor clients by making them aware of investment research's potential as an advertising medium, but the attempt works only if investors read and understand the disclosures. Institutional investors are probably more likely than retail investors to read, put into context, and fully appreciate these new disclosures.

The details of the global research settlement are still being finalized. One possibility that has been suggested is that the *brokerage firms* will ultimately decide or have strong input into which independent research firms are funded. If so, several perverse incentives may result. The first consideration is why a brokerage firm would want to fund an independent research firm that is better at picking stocks than its own analysts are. Will brokerage firms choose to fund the lowest quality independent research firms? Will a brokerage firm want to fund an independent research firm that has a higher percentage of sell recommendations than its own analysts? Again, the result could be that brokerage firms choose to fund the most positively biased independent research firms.

A number of analysts have pointed out that the "flexibility" of the fire wall between investment banking and research in the past has permitted good analysts to keep bad deals from happening.

The elimination of sell-side analysts from the IPO process could result in a higher percentage of unprofitable deals reaching the market and greater uncertainty in expected returns from IPOs in general. Investors in IPOs should expect to be compensated for taking on this greater risk, but in a classic "lemons" problem result, the prices obtained by all IPOs may be reduced and the costs of raising capital through IPOs may be increased for all companies on average.

Not only is the future average quality of IPOs unclear but so is the future average quality of analyst research. Analysts have argued that putting together the complete mosaic of their industry includes knowing as much as possible about the up-and-coming but not yet public competitors. If a complete separation of research and investment banking means they will know less about these up-and-comers, they are likely to be poorly equipped to forecast changes in their industries.

Another uncertainty as to the future quality of research arises from what will almost surely be the

continuing trend to downsize research budgets. Three features of the future seem likely: fewer analysts, less research output, and (probably) lower-quality research. Less and lower-quality research may be the overall unintended consequence.

In summary, the new rules and global research settlement are likely to reduce perceived conflicts of interest. But unless brokerage firms can find a way to charge hard dollars for research or subsidize it through other means, analyst staffs will continue to be cut, fewer companies and industries will be covered, and either trading activity must increase or brokerage commissions must rise or both. No free lunch looms on the horizon.

Institutional investors are and will continue to be in a better position than retail investors to observe and understand the subtleties of sell-side research. Although designed, in part, to improve the lot of retail investors, the new rules and settlements are not likely to render retail investors any better able to compete with institutional investors when attempting to use Wall Street research.

Notes

1. Whether the behavior was *illegal* and whether the U.S. SEC and other regulatory agencies knew and ignored or overlooked the behavior during the running of the bull market are, of course, other important issues, ones that will be litigated for years to come.
2. New NASD Rule 2711 is available at www.nasdr.com/pdf-text/rf02_21_final.pdf. Amendments to NYSE Rule 472 as well as NASD- and NYSE-proposed rule changes to further address analyst conflicts of interest are available at www.nasdr.com/pdf-text/rf02_154_fr_not.pdf.
3. See the press release "SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices" at www.nyse.com/pdfs/global-j.pdf.
4. For the complete analysis, see Boni and Womack (2003).
5. The perspective of AIMR may be found at www.aimr.org/pressroom/media_highlights.html. The AIMR Research Objectivity Standards and comments on them are available at www.aimr.org/standards/.
6. The Sarbanes-Oxley bill may be found at banking.senate.gov/pss/acctfrm/conf_rpt.pdf.

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