

John Kay: Investors must force change on analysts

Published: April 11 2005 in the Financial Times

In the 1970s, investment analysts were humble folk. Prestige, and rewards, remained with those who dealt with clients. But market deregulation reduced stock trading commissions and profitability and allowed banks to acquire stockbrokers. The traditional role of analysts came under pressure, but they found new functions as sales and marketing officers, helping the securities issuance and corporate advisory businesses of their new employers.

Buy notes had always outnumbered sell recommendations. But now every stock was a winner. When academic researchers analysed analysts' recommendations in the late 1990s, they found well over 90 per cent advocated buying.

The conflict of interest was personified by Jack Grubman, telecommunications analyst at Salomon Smith Barney (ultimately Citigroup). Mr Grubman announced his dual role was a benefit, not a problem, for investors. This claim was not quite as absurd as it might seem. The "research" that Mr Grubman's team published devoted only superficial attention to the fundamental value of the companies he promoted. As would emerge later, many of them had no value at all. But Mr Grubman was well informed about market gossip. He realised what was hot, he sensed which deals were in the offing. His enthusiasm for a company became a self-fulfilling prophecy.

This process could not go on indefinitely, and did not. But it could go on for a year or two, and did, and that was the relevant time scale for many fund managers. The outcome damaged not just the wealth of investors, but the health of the corporate sector. Large companies managed their earnings rather than businesses. Strategy became synonymous with acquisitions. Public companies suffered from intense attention to their day-to-day activities, and yet their long-term development received little critical attention.

The conflict Mr Grubman denied is real. Investment banks derive some of their revenues from trading and most from large corporate clients. No Chinese wall can eliminate this conflict. Seeking to expose it, the tenacious Eliot Spitzer, New York attorney-general, first captured the scalp of Henry Blodget, the Merrill Lynch internet guru who was recommending to clients a stock he called "a piece of shit" in an internal e-mail. Mr Spitzer then brought down Mr Grubman himself. The settlement Mr Spitzer reached with big Wall Street companies required them to set aside funds to finance the development of independent research.

Europe lags behind, but a recent paper from Britain's Financial Services Authority would require brokers to split commissions between execution costs and payments for ostensibly "free" research. The purpose is to level the playing field between free, but conflicted, analysis and paid for, but independent, analysis. The FSA plans seek to improve disclosure and end abuses associated with "soft commissions", in which fund managers' expenses are charged to clients, disguised as brokers' commissions for executing trades.

Institutional clients, at least, have begun to see how far they have been taken for a ride. In February, a group of investors led by Robeco, the Dutch fund management company, published a report describing the need for more independent research in Europe. They urged regulatory action by the European Commission.

But more regulation is not the answer. Actions by the likes of Mr Spitzer or the FSA can start a process and help establish a competitive market. But responsibility and remedy lie in the hands of the investment institutions themselves. Pensioners, policy holders and retail investors paid for Mr Grubman's expensive lifestyle and the hope is that, when they realise that, they will stop. There should be less equity research, of higher quality, focused on strategic direction and market position, rather than earnings guidance and market tittle-tattle. This will not happen as long as research is funded through subsidy from corporate activity and the churning of portfolios. Institutions need to be willing to pay for what is valuable to them, and able to refuse to pay for what is not.

The writer, an FT columnist, is also chairman of Clear Capital, an independent equity research company

www.johnkay.com