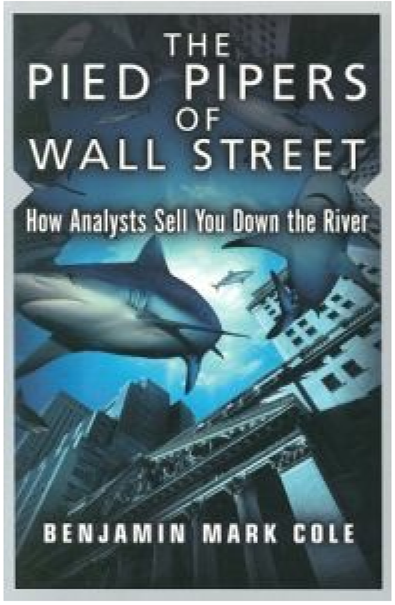

Book The Pied Pipers of Wall Street

How Analysts Sell You Down the River

Benjamin Mark Cole
Bloomberg Press, 2001

Recommendation

The best proof of Benjamin Mark Cole's premise - that brokerage houses have sold out common investors to curry favor with huge corporate interests - is the ease with which he accumulates examples of analysts hyping stocks that later went bust. Can the combination of self-interest, analyst hype, and subsequent stock price implosion somehow be coincidental? Or is it time to start calling a duck a duck (or, for that matter, a quack a quack)? Cole's indictment of Wall Street's most efficient salesmen comes just in time for investors looking for a culprit in the overnight evaporation of billions of dollars in retirement funds. Of course, analysts can't be blamed for the stock-market downturn, but their behavior during the run up deserves the close scrutiny it receives here. *BooksInShort* recommends this book to any investor who suspects that the true talent of the talking heads they see on CNBC might really be turning your money into theirs.

Take-Aways

- Generally speaking, stock analysts aren't objective.
- The days when analysts' first duty was to the retail investor are long gone.
- Analysts have become media darlings who hype stocks.
- Investment banks, which employ analysts, earn millions of dollars in fees from the companies that analysts recommend.
- As a result, analysts are beholden to institutional interests.

- Many brokerages take equity positions in the companies they tout.
- The influence of financial news shows has increased analysts' power.
- Of the 33,169 stock recommendations made by brokerage analysts in 1999, only 125 were sells.
- Analysts typically leak their recommendations to institutional clients before releasing the news to the public.
- Some experts suggest requiring "oral disclosures" for financial news shows stating that analyst advice may not be objective.

Summary

A Market Full of Bull?

In the immortal words of Jack Nicholson in Easy Rider, "It's hard to be free when you're bought and sold in the marketplace." That statement applies to Wall Street securities analysts, who certainly are not free to openly voice their opinions about companies that they follow because they are employed by firms that earn millions of dollars in fees from these same companies. To appreciate the predicament of the pied pipers of Wall Street, consider the case of Biovail Corp. and drug industry securities analyst, Hemant K. Shah.

The Shah Runs Into Trouble

In the early 1990s, Hemant K. Shah was widely sought after for his expertise in pharmaceutical companies. A whisper from Shah could move mountains of cash. So when a young biotech firm named Biovail needed capital, it turned to Shah.

> "Even at an old-line firm like A.G. Edwards, it's the investment bankers who are in the driver's seat, while the stockbrokers - the old customers' men - are merely along for the ride."

In two years, Shah raised about $15 million for the company through private equity financing deals. At the same time he was raising the money for Biovail, Shah was touting the company's stock to the money managers who regularly relied on him for advice.

In 1995, Shah's involvement went a step further. He signed a contract with Biovail to negotiate a licensing agreement with Hoechst-Roussel for Tiazac, Biovail's premier drug for controlling blood pressure. But when Biovail cut a deal with another company instead, Shah felt cut out. He began to complain publicly that he had not been paid by Biovail for his work. In October of 1995, he recommended to his clients that they sell Biovail - an embarrassing move because it came just in advance of a big run up in the company's share price.

> "Wall Street doesn't like a naysayer, and if naysayers are ever wrong, they are 'pasteurized' (sent out to pasture)."

Shah's response was to begin a whisper campaign suggesting that something was wrong with the Tiazac product. He falsely stated that an FDA statistical study suggested the drug was associated with heart attacks.

At the same time he tried to bad-mouth the stock, Shah was buying short, betting more than $200,000 that the stock value would plummet. In late January it did just that, dropping $5 per share to $21. But after a favorable FDA report, the stock market began to rise, and Shah's gamble on his own ability to talk the stock down appeared likely to fail. When legendary investor George Soros gave the stock his imprimatur by buying 20% of it in 1996, Shah was in trouble.

> "At times, one wonders what it would take to prompt SEC action against an analyst at a major brokerage."

Shah then began to claim in conversations with investors that Soros was actually his client, and was manipulating the price of the stock in order to short it later. Shah's dim view of Biovail's prospects was quoted on CNBC, Dow Jones, and Bloomberg News, none of whom seemed aware that the analyst was bitter over his falling out with Biovail, and had a substantial personal investment at stake.

> "Even before a 'buy' recommendation hits the wires, the mutual funds have typically been tipped off to the pending tout, and they often assemble blocks of stock in front of the recommendation."

What was the upshot of Shah's self-interested involvement? Although Shah was called to testify in a civil trial, he continues to be widely cited as an observer of the pharmaceutical industry. Biovail largely shook off the effects of the rumors that circulated around it. But the small investors hurt along the way have never been counted.

The Customers' Men

Stockbrokers were once known as customers' men, which meant that their first job was to take care of the investors, or customers, who entrusted them with their money. As competition squeezed fees however, the pressure to discount transaction costs enticed the brokerage houses to expand into new profit centers: issuing stocks and bonds, and financing real estate limited partnerships, where fees might range from 15% to 20% of the market value.

> "It is one of the great modern ironies of Wall Street: Just as analysts toss down the green eyeshades and pick up the flutes to accompany their investment banking departments, they also become more celebrated, more widely quoted, much more highly pai

Investment banking emerged to replace stock transactions as a major profit center for the big brokerages. In the entire decade of the 1960s, brokerages underwrote about $100 billion of stocks and bonds. In the 1990s, the brokerage industry underwrote between $700 billion and $2.23 trillion each year.

> "Clearly, retail investors are no longer the major underwriting brokerage firms' most important customers. That distinction is now held by corporate clients."

It's little wonder that analysts worry that their real clients - corporations, investment bankers and mammoth mutual fund clients - will have them drawn and quartered if they issue a negative report. After all, brokerage houses collect fees of between 7% and 9% of total underwriting volume. Moreover, brokerages have begun taking a pre-IPO equity position in companies prior to an initial underwriting, further committing them to a given company's fortunes.

> "Analysts, in other words, must forever entrance the buying public with lyrical tales of higher and then higher share prices ahead and the resulting easy, fat capital gains."

In addition to the influence and potential conflict of interest created by investment banking activity and equity positions, there are other concerns. Brokerage investment bankers are collecting fees for arranging mergers and acquisitions, which have exploded in frequency and size. Indeed, today many analysts focus on touting stocks to help bring investment banking business to their firm - and earning hundreds of thousands of dollars in bonuses in the process. For today's analysts, it is more important to be articulate manipulators of the media than expert analysts of financial data.

The $6 Billion Dollar Man

If you want to understand the power of today's stock touts, consider the case of Henry Blodget of Merrill Lynch. You might be interested to learn that this influential analyst was a history major at Yale. After a few months as a reporter for CNN Business News, he signed onto the corporate-finance training program at Prudential Securities in 1994, a program for up-and-coming investment bankers. In 1996 he joined CIBC Oppenheimer as an analyst, where he became a regular on the financial television talk shows.

> "The sort of carnival barkers one finds outside chintzier Vegas casinos come to mind."

On December 16, 1998, with Oppenheimer's small army of stock brokers listening in on his "morning call," he stunned colleagues with his prediction that Amazon.com stock would trade at more than $400 per share within the year. By the closing bell that day, the company stock jumped from $243 per share to $301.75. The jump in valuation of 25% in one day generated some $6.6 billion of new market capitalization for the company, which had never earned a profit - all of this on the basis of a recommendation from an analyst who was not an accountant or even an MBA.

The Dreman Study

Why isn't anyone exploring the apparent conflict of interest that influences the buying decision of the investing public? Wall Street financial columnist David Dreman conducted the largest review of analyst performance ever undertaken, with the assistance of James Madison University Professor of Business Michael Berry. The authors found that the typical analyst's forecast of corporate earnings was off by 42%.

> "The pump-and-dump - the hyping of a stock by brokerages and the institutional investors, so that retail customers will buy it, letting insiders and big traders get out - is not limited only to initial public offerings."

But of greater concern was the direction of the error. Earnings were overestimated three times for every instance where they were underestimated. This is despite the constant efforts by most companies to get analysts to slightly underestimate earnings estimates. In other words, left to their own devices, the analysts would probably be even more wildly bullish. When it comes to picking stocks one year in advance, analysts underperformed the market 75% of the time.

> "But, of course, the basics of stock manipulation are usually simple: Get a lot of stockbrokers at regional firms to start hyping the target stock to their clients. The buying pressure pushes the stock up. The stockbrokers don't let the clients sell until insiders have sold out."

One explanation for this poor record: Analysts typically leak word of an upcoming "buy" recommendation to their trading departments and large institutional clients. This will cause a bulge in the stock price leading up to the date when the recommendation is made public. So by the time the "buy" order is actually released, the stock is actually already somewhat overpriced. Moreover, of the 33,169 stock recommendations made by brokerage analysts in 1999, only 125 were pure sells. This greedy rush for riches has led to some classic Wall Street meltdowns, including the likes of Planet Hollywood, Pets.com and eToys.com.

Playing the Pump-and-Dump

If respected analysts have been compromised, what can investors expect from the second- and third-tier firms that underwrite small-cap or microcap companies? Generally, these companies lack the polish and the compliance departments of the larger firms.

> "It's considered bad form for an employee of a major brokerage to indulge in short trading, much less to boast about it openly."

One of the games these firms play is to talk up the value of a small-cap firm that is ignored by the mainstream financial institutions, and then dump the stock before the value reality hits home. This is the familiar pump-and-dump strategy. Another factor in stock market hype is the use of financial PR firms to promote recognition of a small-cap stock. Some of these firms are compensated in stock rather than fees - setting in motion a drive to push the stock's value regardless of a company's true prospects. Here are some other stock manipulation schemes, as reported by Barron's:

- Parking. An accomplice buys a particular stock on behalf of someone else and "parks" it until it's time to sell. The identity of the true manipulator is thereby hidden.
- False Accounts. These brokerage accounts are controlled by someone other than the person named.
- Matching Orders. Brokerages agree to trade stock with each other, buying back and forth and running the price up, often passing the same shares to each other. This is often done in coordination with a news report or positive financial data. The steadily rising price makes the stock more attractive to retail investors.

Surviving the Hype

How do you avoid being manipulated? Well, there are a few independent analysts who do not have financial axes to grind. These are the good guys, whose advice you may want to seek:

- Analyst Howard M. Schilit (exclusive and expensive)
- The Red Chip Review
- Hulbert's Financial Digest (which rates the performance of newsletters)
- Value Line Investment Survey
- Burkenroad Reports
- Standard & Poors

- iExchange.com (to get advice on specific stock picks)

SEC intervention?

No less an authority than SEC Chairman Arthur Levitt has stated, "I worry that investors are being influenced too much by analysts whose evaluations read like they graduated from the Lake Woebegon School of Securities Analysis - the one that boasts that all its securities are above average." Is regulation looming?

> “The reality, of course, is that the SEC has all but lost control of the game.”

Today, other than a few basic rules on communication, analysts can say whatever they wish, including tipping off their best clients about an upcoming "buy" recommendation. And no one has easy answers about how to regulate relations between analysts and investment bankers. One idea is to have "an oral disclosure" on financial news shows, stating that the analysts quoted might have conflicts of interest. Whether that would outweigh the power of leading financial organizations, who have a proven interest in expanding their ability to manipulate the market value of shares, remains to be seen. And the chance that the U. S. Congress will legislate a split between the underwriting and retail arms of brokerages is remote at best.

About the Author

Benjamin Mark Cole helped launch the daily financial paper Investor’s Daily (now Investor’s Business Daily). For 20 years, he has been a leading financial reporter, writing for *U.S. News & World Report, The Los Angeles Herald Examiner,* and the *Los Angeles Business Journal.* He currently writes the "Wall Street West" column in the *Los Angeles Business Journal.*
