Analyzing the Analysts after the Global Settlement

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Analyzing the Analysts after the Global Settlement

- "Global Settlement" (April 28, 2003)
  - U.S. regulators and ten of the largest investment banking firms
  - Conflicts of interest between brokerage research and investment banking operations
  - Concern: Many "Buy" recommendations too "optimistic"
  - Goal: Future protection of the individual investor

- Examine stock recommendations by the ten firms before and after
  1. Coverage, distribution, and frequency of change
  2. Investors' reactions to analysts' recommendation
  3. Gains and losses from trading on analysts' recommendations
  4. What can we conclude about the settlement's effectiveness toward the objective of educating and protecting investors?

The Global Settlement Firms and Amounts

Firm	Penalty ($ millions)	Disgorgement ($ millions)	Independent Research ($ millions)	Investors Education ($ millions)	Total ($ millions)
Bear Stearns	25	25	25	5	80
Credit Suisse First Boston	75	75	50	0	200
Goldman Sachs	25	25	50	10	110
J.P Morgan	25	25	25	5	80
Lehman Brothers	25	25	25	5	80
Merrill Lynch	100	0	75	25	200
Morgan Stanley	25	25	75	0	125
U.S. Bancorp Piper Jaffray	12.5	12.5	7.5	0	32.5
Citigroup/Salomon Smith Barney	150	150	75	25	400
UBS Warburg	25	25	25	5	80
Total	**487.5**	**387.5**	**432.5**	**80**	**1,387.5**

Note: On August 26, 2004, Deutsche Bank and Thomas Weisel Partners, settled similar enforcement actions.

Why Might Analysts Be Overly Optimistic about Stocks?

- Possible conflicts of interest
  - Company management of the stock being covered
  - Institutional clients protecting the price of holdings
  - Investment banking operation within analyst’s own firm
  - Firm’s proprietary trading operation
  - Analyst’s own trading positions

- Institutional investors: say they read analysts’ detailed reports but ignore their buy recommendations

- For individual investor: post-settlement
  - Disclose conflicts
  - Clearly define recommendation categories
  - Chart performance of analyst making recommendation

Recommendations: Coverage, Distribution, and Frequency of Change

Average of All Ten Firms	1999	2000	2001	2002A	2002B	2003	2004
Standing recommendations	845	930	996	971	881	800	799
Recommendation level (%)							
High	36.6%	39.8%	32.2%	28.4%	34.5%	31.8%	39.0%
Medium	36.8%	35.8%	38.3%	38.0%	45.6%	48.8%	48.2%
Low	26.2%	24.1%	29.0%	32.4%	19.6%	18.8%	12.8%
Other	0.4%	0.4%	0.5%	1.3%	0.3%	0.6%	0.1%
Upgrades (%)	24.5%	18.2%	19.3%			32.2%	38.6%
Downgrades (%)	22.6%	28.5%	34.8%			33.0%	27.6%

----------- Before ------------ | ------ After -------

Initial Market Reactions to Upgrades and Downgrades: 3-Day Returns

Pre-Global Settlement

From Recommendation: / To Recommendation:	"High"	"Medium"	"Low"
"High"	--	**-5.98%**	**-10.18%**
"Medium"	**3.51%**	--	**-7.86%**
"Low"	**3.95%**	**3.33%**	--

----------- Before ------------

Post-Global Settlement

To Recommendation:	"High"	"Medium"	"Low"
"High"	--	**-2.93%**	**-4.79%**
"Medium"	**2.81%**	--	**-3.77%**
"Low"	**4.48%**	**1.80%**	--

------ After -------

Investment Value of Recommendations: Monthly Rebalancing

Average of All Ten Firms

	1999	2000	2001	2002	2003	2004
"High" recommendations	1.8%	0.8%	-1.1%	-2.0%	3.6%	0.4%
"High" recommendations minus S&P 500 index	1.0%	0.9%	0.3%	0.1%	1.2%	0.4%
"Medium" recommendations	1.6%	1.2%	-0.4%	-1.7%	4.0%	0.4%
"Medium" recommendations minus S&P 500 index	0.8%	1.3%	1.0%	0.4%	1.6%	0.4%
"Low" recommendations	1.6%	1.8%	-0.3%	-1.5%	5.1%	-0.1%
"Low" recommendations minus S&P 500 index	0.8%	1.9%	1.2%	0.7%	2.8%	-0.1%
"High" minus "Low" recommendations	0.2%	-1.0%	-0.8%	-0.6%	-1.5%	0.5%

----------- Before ------------ -- After --

Empirical Findings

- After the Global Settlement, the 10 firms on average:
  - Have reduced their research coverage (i.e., number of stocks).
    - Ironically, academic research shows stocks covered by fewer analysts offer greater investment opportunities for investors.
  - Are *more* optimistic:
    - “Low” recommendations decrease
    - “High” recommendations remain about constant.
  - The market reacts less to analysts’ recommendation changes.

Empirical Findings (continued)

- Both before and after the Global Settlement:
  - Analysts issue changes in recommendation levels infrequently (once every 3 to 5 years per firm per company covered on average). As a result, any new information that led to the change is usually quite stale for most of the "life" of the recommendation.
  - Stocks that receive analysts' strongest investment recommendations outperformed the market index (Standard and Poor's 500 Index).
  - So did stocks that received analysts' worst ratings.
  - More often than not, stocks that received analysts' worst ratings outperformed those that received analysts' strongest investment recommendations.
  - Stocks that outperformed the Standard and Poor's 500 Index did so at least in part because they are riskier are average.

Conclusions

- Little change in the recommendations made by the settlement firms or their long-term investment value for investors

- Investors are savvier about recommendations.

Effective 2002: analysts must publish their own historical performance for the stock along with new recommendation

Policy recommendations

- Require *analyst's* performance for all stocks *in aggregate*
- Require *firm's* performance for all stocks *in aggregate*
- Require against benchmarks: vs. market, best vs. worst recs.
- Require risk measurements along with historical returns
- These statistics could be provided by regulators on web sites