



Honesty doesn't pay

Evidence indicates that eternally optimistic stock analysts may have the best career prospects

It just doesn't pay for analysts to tell the truth when they don't like a stock. At least that's the finding of a recent report from the Investment Dealers Association of Canada. As the report explains, it actually pays for analysts to say the complete opposite of what they're thinking in such cases.

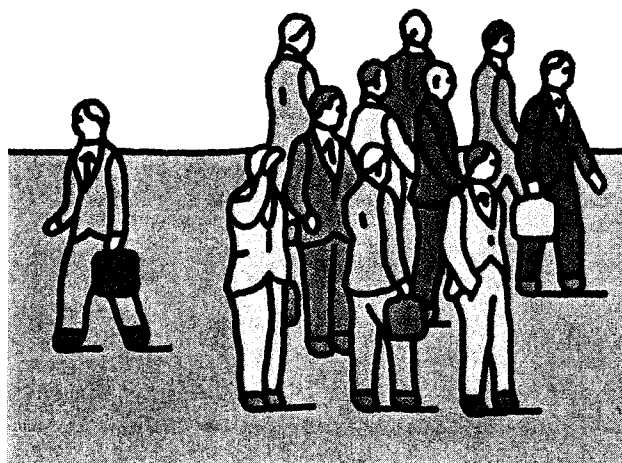
This ingrained bias goes beyond the general Canadian mentality of punishing the bearer of bad news. The IDA report, titled *Canada Steps Up*, lays out the thinking as follows: Sell-side analysts provide value to their employers either by helping to indirectly support investment banking revenue with rosy projections for their firm's clients, or by generating trading commissions from institutional clients.

I have illustrated the investment-banking problem with respect to the over-exuberance of income-trust recommendations ("The fox and the chickens," Nov 7-20, 2005). Many broker-dealers were using their clients as shills to generate investment-banking fees from income trusts. One of the major lubricants (aside from the fuzzy financial reporting) was biased research in favour of their firm's clients.

With the recent chill on investment banking in the trust sector, you can bet some analysts are turning to their second revenue stream, and using biased research to help the cause. The IDA report explains that the bulk of brokerage fees are generated by institutional investors, which generally hold large share positions. When a Sell report is issued by an analyst, retail investors rush to get rid of their small, individual positions without much impact on liquidity. Institutional investors, however, cannot dump large positions in a stock without driving down the market price themselves. Because of this liquidity problem, it's tough to generate commissions from a Sell report, unless a client wants to short a stock. But most short-selling clients don't like communal ideas anyway, so this market has very limited potential.

In addition, issuing Sell reports can hurt analysts in other ways, the IDA says. They can be cut off from company management, making their job harder and diminishing their usefulness to institutional clients. Most important, though, are career considerations.

The report concludes that analysts tend to herd, and fear deviating from the consensus. When the consensus is wrong, analysts suf-



fer little injury relative to one another. While they can improve their reputations by correctly predicting a downturn, this is very risky because they could end up being punished unless their timing is precise.

Indeed, empirical evidence indicates that "accuracy does not improve analysts' career prospects as much as do predictions that err systematically on the side of optimism," according to the report. Hence, it pays to be eternally optimistic. The report highlights this implication as particularly discouraging because, even if "traditional economic conflicts" could be purged from the current system, "careerist concerns would still likely bias objectivity."

The IDA proposes a two-pronged approach to fixing the bias and imbalance of research coverage in Canada. It suggests stock exchanges become the aggregators and publishers of all analyst recommendations so that retail investors can see where their broker falls within the pack. To fix the herding problem, it suggests the exchange pay the analysts with

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the best records of independence to research under-covered companies. This would, hopefully, fix the fact that it just doesn't pay well to offer unique views or cover smaller-cap companies.

The approach is novel, but it's really just a pipe dream. Getting the necessary money would be like pulling teeth. The only real alternative for investors and investment advisers is to use independent research firms to avoid the next investment fiasco. Of course, running an independent research firm myself, you would expect me to say that. Independence eliminates investment banking conflicts, and allows analysts to speak their mind when it comes to, say, income trusts. So it's up to investors in the end to identify and listen to those few analysts who have a record of looking left when the herd is veering right. □

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