

Econ 103 Money and Banking – Dr. Douglas Rice Week 6 Lecture - Corporate Securities

The Markets

The primary market is the market where newly issued securities are distributed to investors. Investment bankers work with issuers to market their new securities in the marketplace. This chapter explains the various ways that investment banking firms are involved in the issuance of new securities, the regulation of the primary market, and the private placement market.



The secondary market is the market where previously issued securities are traded. It differs from the primary market in that the issuer does not receive any capital from the buyer. This chapter describes the features that are common to secondary markets for financial assets.

Investment companies are financial intermediaries which sell shares to the public and invest the proceeds in a diversified portfolio of securities. Each share sold represents a proportionate interest in the underlying portfolio of securities held by the company. This chapter discusses the various types of investment companies, their structures and costs. These intermediaries are compared to exchange-traded funds that are similar but have several advantages relative to investment companies.



I'll leave the specifics to the text and use this lecture to focus on the developments in the analyst/investment banking arena.

The Marketers – The Analysts

Even before the landmark decisions against investment banks for conflict of interest cost them over \$1.5B there was Disclosure Regulation or Reg. FD. This regulation mandates that when a company or company employee disseminates information, it must be disseminated to everyone without prejudice. This means that they can no longer tell the inside scoop to analysts allowing them to have information before the general public. This was viewed as unfair to the average investor and the increase in awareness by the general public created the political situation that demanded action. This was championed by former SEC Chairman Arthur Levitt.



But that was just the tip of the iceberg to investment banks that were making fortunes in fees from bringing IPO's and other offerings to market. What was obvious to all when the market took the plunge at the turn of the century that analysts weren't all doing independent analysis.

For example, many call analysts recommendations a "coded language" as buy doesn't really mean buy and hold is almost certainly a synonym for sell. The SEC reports that one study showed that, in the year 2000, less than 1% of brokerage house analysts' recommendations were "sell" or "strong sell" recommendations. And of course, 2000 was a horrible year for stocks.

The evidence is overwhelming that there is, in fact, bias. First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6:1 in the early 1990s to 100:1 in 2000.

Numerous academic studies have shown that there is statistical bias, a lack of contrary evidence, and possibly most damning of all, common sense dictates that analysts would do what is their own, and their firms, best interest.

Michael and Womack (1999) document that lucrative corporate finance relationships can influence the analysts' recommendations. They state that underwriting transactions are highly profitable for firm and analyst. The role has changed so that analysts are the "pitch" people of the investment bank. They do this for big bucks, double or triple their former salary. 30% of secondary offerings go through a different underwriter and the most



common reasons are the influence of the analyst or the research converge. This means that companies give their business to the most influential analysts. Unfortunately, the most influential analyst isn't the most accurate, it's the one that can make the market buy the most amount of stock at the highest price. Compelling evidence regarding the conflict of underwriting companies and returns of stocks based on their analysts recommendations is

shown in their work. It shows the mean returns for stocks that received a buy rating within one year from their IPO. The green is the independent analysts (non-underwriter) and the red is the analysts from investment banks (underwriter). As you can see, the buy rating from the underwriting company initially got the stock up, but it didn't keep rising. Contrarily, the buy recommendation from the non-underwriting firms moved up initially and stayed up throughout the year.

Further evidence of the conflict in analysts recommendations is found when ratings of companies for which the analyst does underwriting and for companies for which they do not do the underwriting. In 12 of 14 large firms, their recommendations on their own underwriting do worse than their recommendations on other companies in which they don't do underwriting.



Barber et al. found that after a string of years in which security analysts' top stock picks significantly outperformed their peers, the year 2000 was a disaster. During that year the stocks *least* favorably recommended by analysts earned an annualized market-adjusted return of 48.66 percent while the stocks *most* highly recommended *fell* 31.20 percent, a return difference of almost 80 percentage points. This pattern prevailed during most months of 2000, regardless of whether the market was rising or falling, and was observed for both tech and non-tech stocks. While they didn't conclude that the 2000 results are necessarily driven by an increased emphasis on investment banking by analysts, they do note that their findings should add to the debate over the usefulness of analysts' stock recommendations to investors.

Womack's (1996) work shows that analysts buy recommendations far outnumber sell recommendations, 15 to 1, a number that has grown significantly since then. However, the point remains that recommendations are taken more seriously on the sell side than the buy side. Possibly fear is a stronger emotion than greed, nevertheless stocks move down 5% immediately and drift lower for the next 6 months for a total of almost 10% down after a sell recommendation. But buy recommendations move only 3% up and only grow for 4-6 weeks. The most common reasons that analysts give for changing a buy or sell recommendation is that the company is over- or under- valued, mostly under valued, or something new is about or has happened.

This issue came before the Senate Banking Committee. The testimony of Marc Lackritz, President of the Securities Industry Association didn't help his cause at all. He seemed complacent in telling the committee that everyone has had bad years and no one was complaining in 1999 when they were making money. He offers three points in contrast to the flood of academic information offered by others. One is that being wrong isn't the same as trying hard to serve the interest of the investors. Two is that all analysts don't agree in the way they see the situation. Three is even if they agree on the inside company facts, they may not agree on the micro environment in which they operate. So there are bound to be differences. Essentially, he took the position that analysts are going to disagree. Then he goes on to say that they can self regulate and will follow a voluntary "best practices" standard.



On the other hand, David Tice of David Tice and Associates. He commented, "an analyst is just a banker who writes reports. No one makes a pretense that it's independent." He quotes Sean Ryan, a former banking analyst at Bear Stearns Co. when he explained his reasons for recommending NetBank like this: "I put a buy on it because they paid for it." Ryan said he told clients that "we just launched coverage on NetBank because they bought it fair and square with two offerings." His testimony was littered with stories like this and there are plenty more available.



The result of this type of testimony and the dogged pursuit of New York State Attorney General, Elliot Spitzer, is that investment banks are in danger of killing the goose that laid the golden egg. The settlement with the government is just the beginning as now a myriad of private lawsuits will undoubtedly be filed. The most recent IPO's were basically failures and the market remains very soft and leery of new issues. I leave it up to you to decide if that is a good thing or not.