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The Best Research Money Can Buy

LAST MONTH Nutralogix Laboratories, a publicly traded Weston, Fla.-based company, announced its shares had a "strong speculative buy" rating from Empire Research Associates. "We are gratified that such an experienced and recognized analyst has come to this positive conclusion about Nutralogix," noted Troy Johnson, CEO of the company that makes sport drinks and other supplements.

He shouldn't have been surprised. An online search of other Empire reports indicates the research firm has never met a company that it didn't like.

Some Wall Street observers say that firms like Empire, a three-person operation in Chatham that generally bills its clients for research reports, have an inherent conflict of interest and can easily mislead investors with rosy reports that are little more than public relations pitches. But others, including the federal securities and Exchange Commission, say that as long as disclosure requirements are met, there is a place for paid research.

"Investment research for public companies in general, and for smaller public companies in particular, has declined dramatically in recent years," notes the sec in a February draft copy of a research paper titled "Final Report of the Advisory Committee on Smaller Public Companies to the U.S. securities and Exchange Commission."

Noting that the lack of coverage limits access to information by existing and potential shareholders, the report recommends that the SEC "maintain policies that allow company-sponsored research to occur with full disclosure by the research provider as to the nature of the relationship with the company being covered."

Of course, "full disclosure" may be open to some interpretation. In February for example, a Hasbrouck Heights company, Nymox Pharmaceutical, announced in a press release that three "independent analyst reports" had issued "buy" recommendations for the firm.

The release did not indicate whether any money had changed hands, but Nymox had paid the companies-Wallstreet Research, J.M. Button & Associates and Cohen Independent Research Group-for their services.

Nymox did not respond to a request for comment. An SEC spokesman says the agency "is interested in matters relating to disclosure," but would not comment on specific examples.

The SEC disclosure rule gets a thumbs-up from William N. Walling Jr., a co-founder of Empire Research.

"Professional research needs to be paid, but my good will with clients is based on my reputation," he says. "If disclosure is made, then investors know you're being compensated and they can draw their own conclusions."

The Nutralogix release announcing Empire's recommendation noted that the researcher had been "engaged" to provide coverage, but did not specify the compensation. Empire's report, however, does note that Walling will receive $5,000 "from a third party" that a Nutralogix spokesman identifies as a potential investor.

As a general rule, this kind of disclosure doesn't impress Arthur Laby, an associate professor at the Rutgers School of Law-Camden and former assistant general counsel at the SEC.

"Analysts are supposed to be independent and render unbiased views," he says. "They should not be advocates. But to the extent that they're getting paid by a company being researched, their independence could be compromised. Disclosures may or may not be meaningful, especially to a novice investor who may not fully comprehend what's being disclosed."

The issue isn't limited to small-cap companies. In 2003 for example, the SEC and other agencies hit 10 top securities firms, including Merrill Lynch and Goldman Sachs, with $1.4 billion in penalties and other charges relating to allegations that their investment banking arms had pressured their analysts to issue positive reports about clients and other favored firms.

Empire's Walling says he's never issued a negative report about a client firm, but denies that his opinion has been bought.

"I only do a report if my research makes me confident about the company," he says. "I've turned down potential clients because I wasn't comfortable with them."

Paid-equity research can offer value, according to Jordan Kimmel, market strategist for National Securities Corp. and portfolio manager of the Randolph-based Magnet Investment Group.

"Among other benefits, it offers industry and sector comparison data," says Kimmel. "It's an additional tool, but I always advise investors to 'kick the tires yourself before putting money in a company."

Hired research firms don't always act as cheerleaders for their clients, according to information provided by Investars, a Hoboken-based firm that tracks analysts' performance. Two paid-research firms, Taglich Brothers and J.M. Dutton & Associates, have issued "neutral" and "sell" reports in addition to saying "buy," according to Investars' Website.

Out of 48 firms covered by the company, Taglich and Dutton ranked No. 3 and No. 4 respectively when it came to stock-pick performance for the one-year period ended April 3.

Other firms take a different approach. For example, when Pennington-based WorldWater & Power, a solar-engineering and water-management company that trades on the OTC Bulletin Board, engaged Crystal Research Associates to write a report, the New York City-based firm laid out publicly available data about the company without issuing any opinion about the stock's prospects.

"We explain what a company does and let readers make their own decisions," says Jeffrey J. Kraws, a Cranbury resident who is CEO and co-founder of Crystal Research, which covers privately and publicly held businesses. "Our research is readily available so investors and potential business partners can find out about a company without any spin."