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Sell Recommendations On The Rise

By **Alexandra Gekas**

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(Medill News Service) Since the 2003 Global Settlement in which 10 of the top investment banking firms were heavily fined for biased stock research reports, securities analysts are handing down far more "sell" recommendations.

A recent study by Thomson Financial found the proportion of sell recommendations rose to 9 percent in 2005 compared with only 3 percent in 1999.

Buy recommendations decreased to 48 percent in 2005 from 70 percent in 1999.

A separate count by StarMine Corp., a San Francisco-based firm that evaluates stock recommendations, reported that sell recommendations rose to 7 percent in 2005 compared with only 1 percent in 1999 and buy recommendations decreased to 46 percent in 2005 from 71 percent in 1999.

Before securities regulators began investigating analysts' ratings, there was nothing to prevent investment bankers from leaning on their analysts to produce favorable reports on investment banking clients.

"The real conflict of interest was that analysts would get a percentage of any investment banking money they would help generate," said Jennifer M. Fritzsche, a Chicago-based managing director in equity research at Wachovia Capital Markets LLC.

Since the Global Settlement, forced by the Securities and Exchange Commission and New York Attorney General Eliot Spitzer, the protocol has changed in most firms and what Fritzsche calls a "Chinese Wall" has been built between investment banking and equity research due to the settlement's new compliance rules.

At Wachovia things have drastically changed since the settlement, including several pages of disclosures of possible conflicts of interest now added to the end of every stock report, which Fritzsche said is a new practice at most firms.

"The whole industry has changed and it makes it a lot harder for us to work," Fritzsche said. "But [Wachovia] wasn't even involved in the Global Settlement so I have to think the firms that were are even more scared."

The Global Settlement concluded a joint investigation by the SEC and New York following allegations of inappropriate influence by investment bankers over securities research at major firms between 1999 and 2001.

The 10 firms that agreed to the settlement are Bear, Stearns & Co. Inc., Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc., J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Inc., Morgan Stanley & Co. Inc., Citigroup Global Markets Inc., UBS Warburg LLC and U.S. Bancorp Piper Jaffray Inc.

In response to the allegations, one of the firms, Goldman Sachs, established rating distribution guidelines in 2002, while the SEC investigation was still underway.

Goldman requires that no more than 25 percent of its stock reports provide buy recommendations and no fewer than 10 percent recommend sell.

In an April disclosure statement, Goldman reported that 26 percent of the 2,034 stocks it covers are rated buy, 59 percent are rated hold and 15 percent are rated sell, keeping within the firm's guidelines.

"NASD/NYSE rules require a member to disclose the percentage of its rated securities to which the member would assign a buy, hold or sell rating," a Goldman Sachs spokesman said. "For the purpose of the NASD/NYSE rules, Goldman Sachs has determined the indicated percentages."

Other firms involved in the Global Settlement report similar recommendation distributions.

As of April, JP Morgan reported 35 percent of its stocks are rated buy, 50 percent are rated hold and 15 percent are rated sell.

Lehman's disclosure statement reports that 42 percent of its stocks are rated buy, 40 percent are rated hold and 18 percent are rated sell.

Despite the current evidence of substantial change, a study by Leslie Boni, an associate professor at the University of New Mexico's Anderson School of Management, concluded that the 10 investment banking firms involved in the settlement had not improved the distribution of their recommendations as of 2004.

Although the ratio of buy, hold and sell recommendations did change during the investigation, Boni declared, the Global Settlement did not have a permanent affect.

Boni's research showed that during the SEC investigation sell recommendations increased from 24 percent in 2000 to 32 percent in 2002 in the 10 firms.

But after the Global Settlement, she reported, sell recommendations dropped to 13 percent in 2004.

Patrick Dorsey, director of stock analysis at Morningstar Inc., thinks this data could be skewed, however, because it does not make comparisons between years when the economy was in a similar condition.

Dorsey said that Boni's data compares a weak economy to a strong economy when the distribution of recommendations would naturally be different.

But to compare the present distribution of recommendations to the distribution before the Global Settlement, he said, it's necessary to go back to 1998 or 1999 when the economy was also strong.

Regardless of the spread of recommendations from the large investment banking companies, firms that provide only stock research, with no brokerage or investment banking services, contend that their recommendations are more objective.

Among others, Zacks Investment Research, Morningstar and Crystal Research Associates LLC of New York take pride in the independence of their research.

Charles Rotblut, senior market analyst of Chicago-based Zacks, said the firm uses a quantitative model that follows a bell curve.

He said Zacks therefore always recommends the same number of stocks for each category: buy, hold and sell.

"We believe the proportion of stocks that are strong and weak doesn't change," Rotblut said. "We're telling investors there are stocks that have momentum that is stronger than the market, but conversely we say here are the stocks that are lagging behind the market."

Although there is not a target proportion of each recommendation at Morningstar, spokesperson Kathy Panagopoulos said Morningstar also takes a systematic approach to its recommendations.

In May, Morningstar's five-star rating system gave 4 percent of its recommendations a five-star status (strong buy) and 28 percent of its recommendations a one-star status (strong sell).

The rest of Morningstar's recommendations were in the middle, with 43 percent getting a three-star status, or hold. The distribution was the same a month earlier.

"We are paid for our time to insure that what the readers view is factually accurate" said Jeffrey Kraws, CEO of Crystal Research in New York. "We operate under the belief that investors want to know the facts about a company without the fluff or hype, which is why we emphasize our Facts Without Fiction [reports]."

But even for these independent equity research firms, there's pressure not to make sell recommendations.

"Some people are appreciative," Rotblut said. "But I've gotten calls from investors and companies that are unhappy they're listed as a sell."

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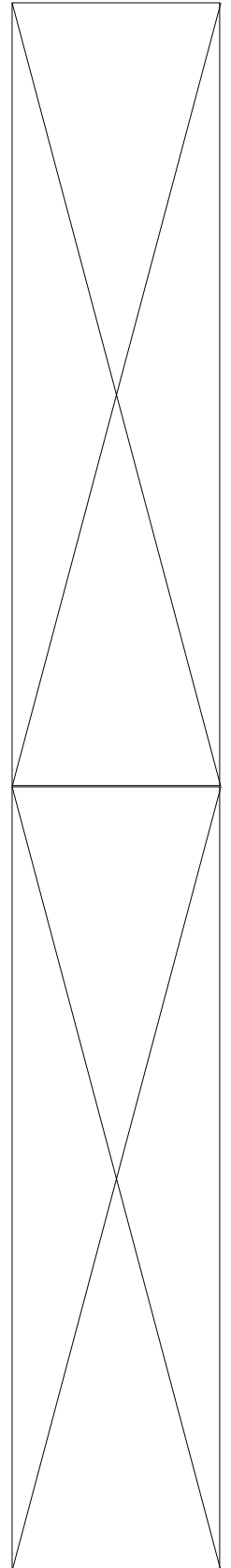
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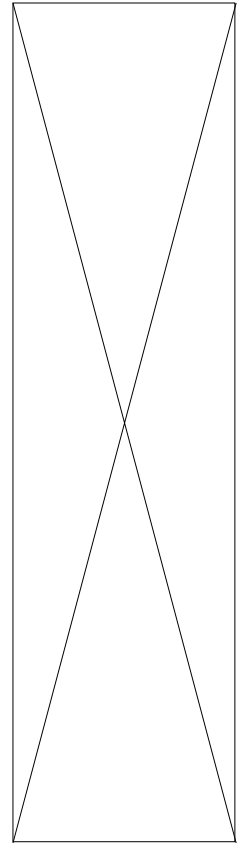
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