the pied pipers of wall street
how analysts sell you down the river

By Benjamin Mark Cole
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review rating

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This book, when it was written in 2000 before publication in early 2001, was brave. It castigates the appalling quality of some US equity research before this issue blew into the public arena. By July 2001, when I read this book, the floodgates had opened, and investors were suing leading Wall Street brokers, and the regulatory authorities had joined the fray.

The theme of this book is not unique, as a few had questioned valuations before the bubble burst in March 2000, and many have questioned them since. As Mr Cole dryly points out in his preface when referring to the Nasdaq: “unfortunately, in the words of the old saw, experience is what you get after you need it”. The book is therefore prescient and courageous.

Mr Cole is a well qualified and experienced financial journalist, and he pulls no punches in addressing this subject. He understands the broking industry, and what has happened to it in recent years – today investment banks make a mere 15% of their brokerage revenue from retail commissions from individual investors. Therein lies the genesis of the inherent conflict of interest in the broking industry, in that the real money is made through corporate finance (underwriting fees, placements, IPOs, M & A, etc), and many analysts are treated as salesmen for stock, rather than independent experts giving advice on the merits.

This US book is relevant to the Australian context, as (perhaps to a lesser extent) we are exposed to the same inherent conflict problems, and we now have here many of the same international broking houses as are covered in this book. Broking and equity research is now a global business, and an analyst of RIO, Amcor or James Hardie has to be international in outlook and has to have access to international research resources. Thus, we really do have the same problem, it is just that we did not see the extremes, as we did not have the capacity (ie, the companies) to emulate the technology bubble in Australia.

Of course, the book contains many examples of the lunacy in much of the late 90s technology company research. However, the discerning reader will see parallels in the capacity for Australian analysts to make consistent buy recommendations all the way down – until “capitulation”. The reader will also understand that the de-regulation of broking in Australia (occurred in the US in 1975) and the advent of discount broking (really web based) on our shores, has completely altered the economic drivers of the Australian broking industry – to the detriment of impartial research. Cole takes us through these painful changes within the US broking industry, and into the current selling of stock for corporate finance objectives. You will therefore gain an appreciation of how this was papered over during the bull market – when there was no justification for complaint when everyone was making money.

With this book, we can look back and see that the Nasdaq mania was not merely due to poor and biased analytical research – no one had a monopoly on foolishness in this market. Investors themselves and the popular press (particularly television) were important components of the story. It was said of Henry Blodget (a prominent technology analyst) that “what you hear from Blodget is that the main reason you should buy internet stocks is because other people buy them. Which is to say, his analysis is itself part of the bubble”.

The individual examples of woeful stock recommendations do tend to pall somewhat, and then Mr Cole addresses structural problems within the banking and finance industry and the trend to financial conglomerates. This he sees as exacerbating the conflict problem, and it appears (to him) that it will get worse before it gets better.

However, amongst the many indictments, the investor will find some practical signposts or lessons, which perhaps are not breathtakingly new, but which are relevant when considering the limits of institutional equity research. As well as explaining some of the skulduggery in the market (eg, ramping of stock), Cole refers to time warn practices which – for those with the time, capacity and bravery – can add to portfolio value. For example, looking for stocks that have not traded up under “buy” recommendations, as they may be too small to be covered by any analyst. These value gems are of course what active small cap managers (with in-house analysts) are looking for in the Australian market, and in so doing the manager is side-stepping the conflicted, biased “buy” recommendation, and is in fact profiting from it’s absence.

There is a good discussion of short sellers, and in particular of Mr Stanley Brillo, who appears to have correctly called the current bear market. The point is well made that short sellers appear to be better at stock picking than brokerage analysts “perhaps because shorts are free of the baggage brokerage analysts carry”. Finally Mr Cole puts the knife in by referring to the disappointing ability of analysts to predict earnings, let alone call forward market levels. One almost gets sympathetic to the plight of analysts – until he discusses the difficult options faced by private investors, and that, he admits, is not entirely happy either.

The book is rated 5 today, as to some extent the debate has passed by and has now reached another level – both in the US and in the UK. On August 1, FT.com reported the chairman of the UK Financial Services Authority, Sir Howard Davies, as saying that “There is some evidence both that analysts’ recommendations have been systematically more positive than market performance would justify and, more seriously, that analysts’ recommendations in relation to companies with which their parent house has a relationship are systematically more positive than the average”. What a surprise.

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