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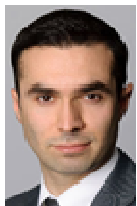
Warning: Analyst!

Investors are bombarded with analyst recommendations. Those who have chosen to follow them have suffered great losses in the past. The following commentary explains why a good dose of caution is important when it comes to evaluating analyst recommendations.



Admittedly, success in the stock market sometimes requires some luck. However, if you decide to invest in a stock, it's a good idea not to rely completely on luck but to take a closer look at the company you want to invest in. A thorough business analysis, however, is extremely time-consuming and only a few investors have the necessary time, expertise and access to information to properly conduct one. Many therefore understandably rely on analyst reports when making trading decisions. This calls for a great deal of caution, however. As an investor, it's especially important to be very clear on whose opinion one chooses to follow.

In the financial world, there is a clear distinction between buy-side and sell-side analyses. To better understand the difference between these two types of analyses, it's worth taking a look back at the past.

Most analysts – even those employed by brokerage firms – used to be considered independent. Their independence was guaranteed by a clear division (Chinese wall) between the brokerage and investment banking businesses of a financial institution. The division guaranteed the high quality of analyst reports by preventing any conflicts of interest. However, greater competition spurred by online brokers (among other factors) led to an erosion of profit margins in stock trading. Ultimately, the Chinese wall crumbled for financial reasons, fundamentally altering the role of broker-analysts and effectively turning them into salesmen. In this case, at least, the financial sector was impeccably transparent, going so far as to introduce the term "sell-side analyst."

While these analysts used to value high-quality analysis, today their task consists primarily of generating commissions, i.e., income for their firms. Buy-side analysts, on the other hand, work in asset management and produce studies that are meant to increase the value of their managed assets.

While sell-side studies may indeed be worth a look, they are always critically received by buy-side analysts. The research[1] shows that buy-side analysts generate better returns from

[1] See Stanzel, M.: "Qualität des Aktienresearchs von Finanzanalysten" (Quality of Stock Research by Financial Analysts), Giessen 2007, et al.

asset management when they are critical toward sell-side studies.

A major problem with sell-side reports is that their investment horizons cast doubt on otherwise credible, well-crafted analyses. The shorter the holding period of a stock, the more commissions are generated. Many analyses are therefore designed to encourage investors to reallocate their portfolios on a frequent basis. The resulting transactions are, of course, a true example of how "one man's joy is another man's sorrow." While sell-side analyses are typically based on a stock holding period of less than a year, buy-side analyses call for periods of three to five years. Longer-term investments like these aren't quickly discarded just because a company posts disappointing quarterly results. Rather, the stock is sold only if fundamental changes are detected that cast doubt on the long-term success of the company.

In contrast to buy-side analysts, sell-side analysts are incentivized to produce as optimistic a forecast as possible in order to generate higher transaction volumes. This is because a positively rated corporate stock can be bought again and again and by any investor. A stock with a sell recommendation, on the other hand, can be sold only once and only by holders of the stock.

In light of this fact, it's no wonder that sell-side analysts overwhelmingly give positive recommendations. After all, when their employer benefits, their careers benefit as well. Studies[2] of sell-side analyst careers indicate that career opportunities noticeably improve when an analyst produces positive analyses.

Because the sell side wants to increase commissions, its goal, unlike that of the buy side, is to make its analyses available to as wide an audience as possible. However, this automatically leads to comparisons of their recommendations against those of other analysts. In theory, this type of competitive pressure should improve quality. However, it also sets processes in motion that favor a herding behaviour and make an objective analysis difficult. The research shows[3] that following the consensus is more beneficial to an analyst's career, irrespective of whether that consensus is right or wrong. On the other hand, a wrong recommendation that goes against the consensus can be disastrous for a career. Brave analysts who go against the prevailing sentiment of the market, as the studies show, are penalized, making them far more likely to leave the profession.

The above analysis clearly shows that buy-side analyses are of greater interest to investors due to their lack of conflicts of interest. Unlike sell-side reports, however, they are seldom published, for the very purpose of guaranteeing their quality. Thus, virtually all analyses available on a wide scale come from the sell side and should thus be met with skepticism.

To rule out conflicts of interest (part of principal-agent problem discussed by economists and political scientists), ARVEST has never since its founding in 1974 employed sell-side analysts. Likely as result, all of our stock funds have considerably outperformed the market.

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[2] Stanzel (2007), page 138

[3] Graham, J. "Herding among investment newsletters: Theory and evidence," The Journal of Finance 54, 237–268