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A stockpicker confesses to recommendations you should not buy

Daniel Davies

The flaws of buy-sell ratings on equities, according to Daniel Davies

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All of us who work as research analysts or stockbrokers have made recommendations we would rather not talk about. They come up in conversation at the worst moments, usually when you are sitting in an office in Mayfair explaining to a multimillionaire hedge fund manager exactly where he has got it all wrong. You annoy your host by pushing things too far or appearing a mite too self-satisfied, and he interrupts your stream of thought and inquires, languidly as a viper: "What about your Buy on Amalgamated Widgets?"

You know Amalgamated is down 16 per cent for the quarter to date; all you can do is play for time. Still, as you wait for the awkwardness to end, you fantasise about telling the truth.

It might not have been a straightforward error; perhaps this was a Brown-Nosed Buy. Career advancement does not come to people who make enemies by saying nasty things about the boss's top client. Senior people can help you in all sorts of ways. Jack Grubman, a telecoms analyst at Citigroup's Salomon Smith Barney unit, apparently once raised a rating to suit the bank's chief executive, who he hoped would help get his children into an exclusive kindergarten. (Sandy Weill denied having done anything wrong.)

Mr Grubman was banned from the industry for life, but sycophancy can cloud your judgment without obviously crossing the line. Perhaps the Amalgamated boss is going to be the keynote speaker at a conference you are organising. You were happy with the Buy recommendation when you sent the invite, but that was two profit warnings ago.

Then there is neglect. You should have downgraded Amalgamated two months ago — and you know it, but you have had results season, the management away day, weeks of work on an initial public offering that never happened.

When you get around to it, you will have to contend with the parlous state of the rest of the industry. All of Amalgamated's competitors are doing as badly or worse. But your boss has dictated that all recommendations have to be made on a sector-relative basis; one of these widget makers will have to be a Buy. Perhaps more than one: fund managers do not want to talk to analysts about their Hold recommendations.

> If you were actually managing money, you would cut your losses — but reversals are embarrassing

Bending to such pressure is at least your own silly fault, unlike the Client-Driven Buy. As the fellow opposite you knows full well, Amalgamated is the biggest holding of the biggest hedge fund on your client list. And the manager responsible for that position is an arrogant so-and-so who does not like being disagreed with.

Everyone recommends buying Amalgamated because no one wants a storm of nastygrams that would be the consequence of downgrading it. The analysts meet up in pubs with all the other fund managers, and discuss what they really think of Amalgamated. Often they are rather frank about what they think of its biggest holder, too.

The hapless equity analyst is no stranger to embarrassment even when his recommendations are sincere. Perhaps buying Amalgamated when you recommended it would have made perfect logical and financial sense — the business is sound, an obvious catalyst for valuation improvement is just round the corner.

Still, it is not working, for reasons you don't understand. If you were actually managing money, you would have cut losses immediately (or been forced to do so by your risk manager). But you are not. And downgrading a falling stock so soon after upgrading it is embarrassing. So you have stuck with it, dropping your price target a couple of times in the futile hope that nobody will notice.

Such stories can probably be told for as many as half of all Buy recommendations. So sensible fund managers do not pay attention to the "Buy/Sell/Hold" in the corner of the research notes, except as a starting point for discussion or a disciplinary device for excessively bumptious brokers.

But these things are still published, and there are still plenty of less sophisticated punters who take the headlines seriously. With the growth of automated "scrapers", it's quite possible that changes in published recommendations are as important now as they have ever been. "Nobody takes this stuff seriously" would be a flimsy argument if regulators came knocking after investors had been hurt.

The "Buy/Sell/Hold" headline is both heavily regulated and more or less worthless. Perhaps some courageous stock brokerage could be the first to take the plunge and get rid of them.

The writer is a former investment banker and a senior research adviser at Frontline Analysts, a provider of equity research

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