Are "Buy" Ratings Nearly Worthless?

Integrity Research Associates, in a post titled "When a 'Buy' Isn't Really a 'Buy'", recently highlighted the untrustworthiness of Wall Street stock ratings. This article comes on the heels of CFOs admitting to manipulating earnings and further demonstrates just how deceptive Wall Street research can be. The following are examples of when a 'buy' rating is not really a buy rating.

1. "Brown-Nosed Buy" – a buy rating to "keep the boss happy" or avoid upsetting the CEO, who happens to be the keynote speaker at a conference the analyst's firm is organizing.
2. "Client-Driven Buy" – a buy rating for a stock that is a large holding of one of the analyst's largest clients, to avoid upsetting the client or questioning their stock selection.
3. "Industry Buy" – a buy rating for a stock within an industry because the analyst's boss has made it clear that recommendations are done on a sector relative basis and that at least one stock in an industry has to be a 'buy.'
4. "Neglect Buy" – a buy rating that arises when an analyst fails to downgrade the stock even when he/she knows they should. Perhaps, other work got in the way of downgrading and backtracking now would be embarrassing.

These findings are from the Financial Times article based on confessions from former Credit Suisse analyst Dan Davies. Most alarming may be his admission that sensible fund managers do not pay attention to buy/sell/hold ratings yet plenty of less sophisticated investors take the headlines seriously.[1]

As our clients know, New Constructs' ratings are unbiased, fully independent and reflect analysis of the entire annual report, not just [misleading] accounting earnings. We think this article should compel more investors to stop relying on Wall Street research.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

[1] Davies, D. (2015, August 12). A stockpicker confesses to recommendations you should not buy. Retrieved from Financial Times

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

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Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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