

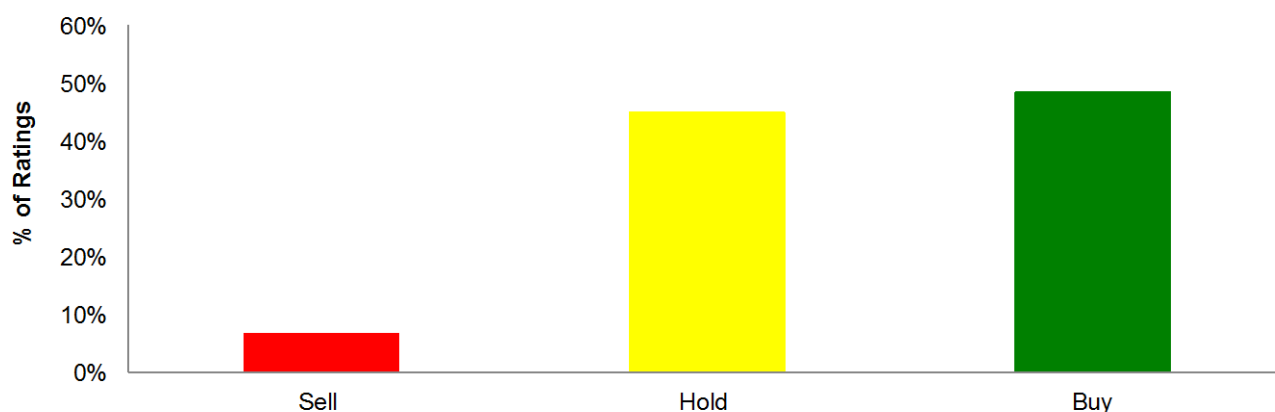


A Cautionary Tale on Sell-Side Ratings

Sell-side analysts most often assign companies “buy” ratings and almost never tell investors to “sell.” An [analysis from Bespoke Investment Group](#) found that out of 12,122 ratings for all stocks in the broad market index, less than 7% were labeled sells, as shown in Figure 1. A more recent [CNBC analysis](#) reported that the percentage of newly issued ratings of “sell” or “underweight” was only 5% of the total. This phenomenon is not new to regular market followers, and it was on full display surrounding the IPO of Snapchat (SNAP).

Figure 1: Snapshot of Typical Sell-Side Investment Ratings

Wall Street Rating Breakdown



Sources: Bespoke Investment Group; ratings as of February, 2015

Are Underwriter Ratings Particularly Conflicted?

Research analysts are in a tough spot when it comes to ratings on IPOs their firm’s investment banking department has underwritten and sales/trading teams have distributed. They don’t want to risk:

1. Angering clients that may have bought the IPO through the analyst’s firm.
2. Offending the bankers (who typically run the firm) that worked hard to win the IPO deal.

In the words of Bloomberg’s Matt Levine:

“If you are publishing a research report weeks later, you know that a bunch of your investor clients bought SNAP in the IPO. You know others were pitched the stock in the IPO, and didn’t buy, and presumably won’t now. Putting a buy rating on the stock will help the former group (the stock will go up!), without much hurting the latter group (what do they care?).”

Exhibit A: Snapchat (SNAP) IPO

SNAP was our [Danger Zone pick](#) on February 6. The undue influence that an underwriter can potentially place on research, even when it is unspoken, at least appeared to be on display around this high-profile deal. The stark difference between research coverage issued prior to (by non-underwriters) and subsequent to (by underwriters) the actual IPO speaks for itself.

Eleven of the twelve analysts who initiated coverage prior to the IPO rated SNAP “hold” or “sell.” As soon as the publishing window for underwriters was open, 13 underwriters initiated coverage on March 27, 2017. Nine of the banks issued “buy” ratings, four issued “hold” ratings and none issued “sell” ratings. A summation of the underwriter’s [sunny report roll out can be read here](#). Six additional, non-underwriter firms initiated coverage during April. All were “neutral” or “hold.”

There are now over 30 publicly visible analyst ratings on SNAP with an average recommendation of 2.8 on five-point scale, indicating a very slight overall positive bias. The average analyst price target of \$23.50 (high: \$31 / low: \$10 implies upside of just 3% from current levels. We find it notable that projected appreciation is a mere fraction of the 99% 2018E revenue growth that analysts have used to craft these price targets.

Figure 2: SNAP's Rating Distribution Evolution

Investment Ratings	Sell	Hold	Buy	Total
Pre-IPO non-Underwriters	5	6	1	12
Post-IPO Underwriters	0	4	9	13
Post-IPO non-Underwriters	0	6	0	6
Current Ratings	5	16	10	31

Sources: New Constructs, LLC

An Insider's Alternative View on Buy Ratings

Apart from ratings skewing towards "buy", we've [previously covered](#) why some "buy" ratings are not truly "buy" ratings. Specifically, from a piece in the [Financial Times](#), a former Credit Suisse analyst, Dan Davies, detailed scenarios when an analyst might issue a deceptive buy rating. The scenarios include:

1. "Brown-Nosed Buy" – a buy rating to avoid upsetting the CEO of the firm under coverage.
2. "Client-Driven Buy" – a buy rating for a stock that is a large holding of one of the analyst's largest clients.
3. "Industry Buy" – a buy rating for a stock because the analyst's boss has made it clear that ratings 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 arising when an analyst fails to downgrade a stock even when he/she knows they should have; backtracking now would be embarrassing.

The most alarming detail in Mr. Davies' confession is that buy/sell ratings are largely ignored by institutional investors but dangerous to retail investors.

Investors Need Independent Research

Though Wall Street may provide some of the best research in the world, the potential and actual conflicts are obvious, have always existed and are inherent in the sell-side business model. Not all the Wall Street research is conflicted. However, one can never know which reports are or are not conflicted since all the disclaimers in every report warn that each report may be conflicted in a myriad of ways. Equity research is a cost center and does not directly generate any revenue. Analysts provide value to the company, not by issuing accurate research reports, but by convincing clients to trade and companies to use the bank as an underwriter.

Independent due diligence is part of fulfilling fiduciary duties, and it [tends to pay](#). Only by reading through the footnotes and making adjustments to [reverse accounting distortions](#) can advisors and investors meet the fiduciary duty of care.

This article originally published on [May 8, 2017](#).

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

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide [tangible, quantifiable correlation](#) to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our [robo-analyst technology](#) empowers us to perform for thousands of stocks, ETFs and mutual funds.



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.