# Investment Research

*Investment research presented in papers, academic journals and other periodicals that may be of interest to individual investors.*

## Research Reports: Buyer Beware

***Analysts' Research Reports: Caveat Emptor****, by Amitabh Dugar and Siva Nathan, appearing in the Winter, 1996 issue of The Journal of Investing, published by Institutional Investor, 488 Madison Ave., New York, N.Y. 10022; (212) 224-3185.*

How should individual investors view analysts' research reports?

With a healthy dose of skepticism. That, at least, is the argument made by two professors, who summarize the disadvantages faced by individual investors when trying to use brokerage firm analyst reports.

Many studies have found that analysts' earnings forecasts and investment recommendations tend to be overly optimistic. In this article, the authors argue that incentives within an analyst's firm are a major source for this optimistic bias; these incentives arise from the conflicts of interest within firms that issue research reports and at the same time have other business relationships with the companies that are the subject of their reports.

The biggest disadvantage individual investors face when using analyst research reports, according to the authors, is a lack of knowledge concerning these possible conflicts of interest and potential sources of bias.

Investors should focus on two very basic issues when reading research reports: What does the analyst *really* mean, and when did the analyst *really* prepare the report?

The authors note that analysts depend heavily on corporate management for information, and a bad report can have repercussions for this flow of information. Thus, analysts are very careful about phrasing misgivings concerning firms they follow, and may not even voice those misgivings. In addition, bonuses given to analysts are often based on ratings the analyst receives from their firm's sales force, whose primary focus is commissions, and restrictions on short sales and the limited use of options results in buy recommendations generating more trades.

The result, according to the authors, is that analysts tend to use terms such as "hold" or "speculative hold" instead of "sell" to downgrade a stock. In a study of 250 reports issued between 1983 and 1988, the authors found numerous euphemisms for "sell," including: "underweight," "lighten up," "fully valued," "overvalued," and "source of funds." While institutional investors tend to recognize the true meaning, individual investors are less familiar with the terminology. And, since most analysts do not disclose all of the gradations within their rating system, it isn't easy to put a particular rating into perspective to make the appropriate decision.

Business relationships also may lead to a bias in analyst recommendations, the authors state. Most firms employing analysts also have underwriting and investment banking deals; to maintain these relationships, companies need to be portrayed positively, and there may be pressure against issuing a negative research report on a company that is a client.

To study this possible source of bias, the authors examined 250 research reports from investment banker analysts and compared them to a matched sample of 250 non-investment banker analysts' reports. The study found that the investment banker analysts' earnings per share forecasts were, on average, 6% higher than those of non-investment banker analysts. In addition, investment banker analysts issued 25% more buy recommendations, 46% fewer sell recommendations and 23% fewer hold recommendations than non-investment banker analysts. These more optimistic recommendations were unjustified when compared to market returns, the authors noted, adding that the market doesn't appear to take such biased reports seriously.

While these relationships may introduce a bias, the authors point out that company relationships are disclosed in the analysts' research reports, although usually in smaller print at the end of the report.

The other problem for individual investors concerns the timing of a report. With the ability to transmit electronically to investors, on-line research reports are becoming common. While this gives the appearance of a more level playing field, the authors note that firms are pricing this research differently for various categories of investors. The date on the report is not necessarily a reliable indicator of when the report was actually prepared, the authors warn, and despite a timely date it could in fact have already been transmitted to other customers. The authors point to several studies that examined the market reaction to analysts' earnings forecasts revisions; these studies found that the market reacts much more strongly during the nine-day interval preceding the research report date than during the three-day interval surrounding the date. This, the authors point out, is consistent with the hypothesis that certain customers receive the information before the date of the report.

The authors offer several recommendations for individual investors using analyst research reports. These include:

- Try to understand what the research report really means by studying past reports and any other information about the company.
- Check to see if there are any client relationships between the analyst's firm and the company whose stock is being recommended; if there are, discount optimistic recom-

mendations and use reports from other brokerage firms without such a relationship.

- Read the entire report and check for disclosures about relationships, which are typically made in the footnotes.
- Try to get research reports on the same firm from several different analysts.

***The bottom line for investors***: *As the study's headline translates: "Buyer Beware!" Some analyst reports may provide useful insights, but further research from other sources is always warranted.*

## The Bear Look

***Bear Markets May Be in Hibernation, But They Shouldn't Be Forgotten****, by Brett Skakun; a study appearing in the Fourth Quarter 1996 issue of On Course, published by the Consulting Group, a division of Smith Barney, Bethesda, Md.*

As the market keeps hitting new highs with nary a bump in the road, fewer and fewer investors have actually experienced a true bear market. Indeed, the most recent drop of over 10% occurred way back in October 1990.

Bear markets are painful, but they do force investors to come to terms with stock market risk. Large and lengthy drops can cause investors to panic and make emotional decisions, possibly withdrawing at inopportune times. An understanding of bear markets can help an investor more accurately assess how much of a loss they can withstand and prevent a panic attack when the inevitable drop occurs.

So what does a bear market look like? A brief study of bear markets by Smith Barney's Consulting Group reviewed the data.

The study examined stock market drops of 10% or more since 1940. Table 1 presents the percentage decline (which does not include dividends), duration, and recovery time of these market drops. For purposes of the study, the duration of a stock market decline starts from the peak and ends at the bottom; the recovery period is the amount of time it takes for the market to go from the bottom back up to the same level as the previous peak.

The study found that the duration of these declines has ranged from one month to a little more than two years. Recovery periods ranged from one month to almost six years, but most have taken less than one year.

All major drops start as smaller declines, and the study notes that two-thirds of the 10% declines developed into bear market drops of 20%. On the other hand, less than half of the 10% declines developed into bear market declines of greater than 25%.

In addition, the study found that the S&P 500 has often jumped substantially following a market decline. Most recently, the market rose 25% in the four months following the 1990 bear market and 19% in the five months following the 1983-84 decline.

***The bottom line for investors***: *The timing of bear attacks remains elusive, and recoveries are often swift. You can best withstand a bear attack if you know in advance what to expect and are still around (invested in stocks) for recovery.*

**Table 1.**
**Major Stock Market Declines Since 1940**
**(S&P 500 index)**

| Year | Depth of Drop (%) | Duration of Decline* (months) | Duration of Recovery** (months) |
|---|---|---|---|
| 1990 | –20 | 3 | 4 |
| 1987 | –34 | 3 | 20 |
| 1983–84 | –14 | 10 | 5 |
| 1981–82 | –26 | 19 | 2 |
| 1973–74 | –48 | 21 | 70 |
| 1968–70 | –36 | 18 | 21 |
| 1966 | –22 | 8 | 7 |
| 1962 | –26 | 6 | 14 |
| 1959–60 | –14 | 15 | 3 |
| 1956–57 | –22 | 15 | 11 |
| 1955 | –10 | 1 | 1 |
| 1953 | –15 | 8 | 6 |
| 1950 | –14 | 1 | 2 |
| 1946 | –27 | 5 | 44 |
| 1940–42 | –42 | 28 | 26 |
| **Average** | **–25** | **11** | **16** |

**From stock market peak*
***From stock market bottom to level of previous peak*