Investment Research

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

Underwriters and Analyst Recommendations

Conflicts of Interest and the Credibility of Underwriters' Analysts' Recommendations*, by Roni Michaely, Cornell University, and Kent L. Womack, Dartmouth College; preliminary paper to be presented at the 1996 Western Finance Association annual conference, June 19-22, Sunriver, Oregon.*

If your brokerage firm is an underwriter for an initial public offering, is the firm's analyst recommendation for that stock better than an outside analyst due to superior information available to the analyst?

Or is it more likely to be biased in favor of the firm's underwritten client?

Preliminary research suggests the latter.

That, at least, is the finding of a paper to be presented at the 1996 Western Finance Association conference in Sunriver, Oregon, in June. The paper, "Conflicts of Interest and the Credibility of Underwriters' Analysts' Recommendations, by Roni Michaely, Cornell University, and Kent L. Womack, Dartmouth College, won the 1996 AAII outstanding paper award. [The paper is still preliminary, and is not available for distribution from AAII. If you would like a copy of the paper, please contact the authors directly].

The paper examines how possible conflicts of interest within an investment banking firm may affect analyst recommendations of initial public offerings.

The possibility of a conflict arises at investment banking firms with both corporate finance and brokerage operations. The corporate finance group generates its profits by, among other things, taking companies public and helping to market their shares. The brokerage group generates profits from stock trading and provides research information to clients to aid in their trading decisions.

The conflict can be particularly evident in the initial public offering process, according to the authors, who point to the well-known promise often given by underwriters to their clients that their firms will provide analyst coverage of the stock. This is important to new firms in the marketplace, who want to make themselves known to the investing public, particularly institutional investors.

On the other hand, research analysts from the brokerage operations promise to supply investment clients with objective information.

The conflict between the two divisions could produce one of two results, according to the authors:

- The analysts of the underwriters may be more likely to make overly favorable recommendations on issues going public and they may be more likely to issue favorable recommendations on firms that have traded poorly in the secondary markets after the offering is completed; or
- The analysts of the underwriters may have better information than their analyst competitors at non-underwriting firms, which could provide more accurate recommendations both before and after the offering.

In the study, the authors found evidence of the first result, and not the second. The authors compiled a list of companies with initial public offerings between 1990 and 1991. Recommendations of these offerings made by research analysts who worked at the firm that underwrote the offering were then compared with recommendations made by research analysts at firms not associated with the underwriting.

The study found that recommendations from analysts of companies that the analyst's firm had underwritten substantially trailed the market average by 13.9% for two years from the time of the initial public offering. In contrast, recommendations of initial public offerings made by analysts that were not with the underwriting firm outperformed the market 32.1% over the same time period.

The authors also found that the market tends to discount the recommendations of offerings made by analysts of the underwriter, but the long-term results suggest that the market does not recognize the full extent of the bias.

The bottom line for investors: *If your broker recommends an initial public offering, find out who the underwriters are; if your broker's firm is an underwriter, you should probably view the recommendation with a healthy dose of skepticism.*

The World Markets as a Hedge

Do World Markets Still Serve as a Hedge? *by Claude B. Erb, First Chicago Investment Management, Campbell R. Harvey, Duke University, and Tadas E. Viskanta, First Chicago Investment Management; published in The Journal of Investing, Vol. 4, No. 3, Fall 1995.*

Investors are increasingly setting their sights beyond the U.S. equity markets and are including international stocks in their investment portfolios.

One clear goal is risk reduction—reducing the volatility in returns to a portfolio by investing in assets that behave differently in different market environments. Many international investors are hoping that their foreign stocks will be unaffected by U.S. market and economic conditions, helping to shore up their portfolios when their U.S. stocks are down, although possibly serving as a drag when U.S. markets are up.

Do foreign markets serve this function?

Well, sort of, according to one recent study.

"Do World Markets Still Serve as a Hedge?" by Claude B. Erb,