

An Insider's Look at Brokerage Research

An Interview With Mike Mayo

Article Highlights

- Sell-side analysts analyze companies, write research reports, and give buy, hold and sell recommendations.
- Analysts who say something negative can experience backlash, including an inability to get questions answered.
- Investors should watch out for executives who don't speak in clear terms, act defensively or don't disclose reasonable information.

Mike Mayo, a top-ranked bank analyst, authored "Exile on Wall Street: One Analyst's Fight to Save the Big Banks From Themselves" (John Wiley & Sons, 2011). He recently talked with me about how investors should approach analyst stock research and a company's own assessments.

—Charles Rotblut, CFA



as mutual funds, pension funds, hedge funds, different state teacher plans, and any large institution with a lot of money to invest that will at least partly invest in equities.

Charles Rotblut (CR): Could you explain what the role of a sell-side analyst is and what exactly a sell-side analyst does?

Mike Mayo (MM): I'm a sell-side bank analyst, and my job is to analyze large banks, write reports about those banks, offer an opinion about whether those banks are doing well or poorly, and offer an opinion on the stock of those companies—either to buy a bank stock or sell a bank stock.

More generally, a sell-side analyst publishes reports on companies in any industry. What's unique about a sell-side analyst is that the research gets distributed to those managing money. I don't actually manage money myself but, in effect, I advise those who do. Something else unique about my position is that I will continue to follow a company whether I think it is a buy-, hold- or sell-rated stock, whereas those who manage money, once they sell the stock, sometimes they might not have the same level of analysis as they would if they actually owned the stock. So there is a continuity of analysis and oversight that I have in my job that you might not always have with those on what's called the buy side, or those actually managing the money.

CR: And who is the typical audience for your research?

MM: You could almost think of my analyst role as similar to a wholesaler. I advise large money managers such

CR: Obviously, you publish a buy, sell or hold recommendation, and a lot of firms are using outperform or underperform ratings instead. When you change your rating—say, downgrade a stock—are you commonly questioned or challenged?

MM: Right now, only 5% of all ratings on Wall Street are "sell" ratings. That's not the way the system is supposed to work. If you think that the stock market is efficient, then you would think that there would be an equal number of "buy" ratings as there are "sell" ratings. So that says the system is skewed; it's abnormally positive in terms of the views of the Wall Street analysts. And there are all sorts of pressures when an analyst wants to go ahead and say something negative about a company, even if it's not a "sell" rating. If an analyst wants to say "Company XYZ is doing something poorly," there can be all sorts of backlash. I've seen that backlash in my career, and I write about that backlash in my book, "Exile on Wall Street."

First, there's the potential for backlash from the company itself. The largest banks are \$2 trillion in assets—that's a big number. To put it in perspective, that's \$1 million times \$1 million times two: Two trillion dollars. And that's 20 times larger than the largest banks were a couple of decades ago. So when one individual says something negative about a bank with \$2 trillion of assets, there's always the potential for some sort of backlash, and I've seen that in my career. I've seen that over the last 20 years, as I try to explain in

plain English in my book. That backlash can include being ridiculed in front of hundreds of investors when the CEO speaks. The backlash can include lack of access to top people who run the company. It can include an inability to ask questions on the once-a-quarter conference calls when the companies release their earnings results. And it can mean phone calls that are returned late or not returned at all. So there are all sorts of backlashes.

But, in addition, there's the lack of certain perks. Say something nice about a company and the analyst can be invited in to meet with the CEO, or the CEO of the company will come to a conference that the analyst is holding, or the analyst will go talk to one of their big mutual fund clients and the CEO will actually go with that analyst. But say something negative about a company and the company will do less of those types of favors for the analyst, not to mention the potential backlash.

CR: *And do you think anything's changed? I know that in the aftermath of the Internet bubble, in early 2001–2002, similar points were raised. Do you think anything's changed since that time, or do you think it's still the same ongoing pressures?*

MM: The main reason I wrote my book "Exile on Wall Street" was that many accounts of the financial crisis were written from a third-person point of view. I think what's unique about "Exile on Wall Street" is that it's from a first-person account. I'm still in the business, writing about the business.

But the book is not just about the financial crisis. It's about the two decades leading up to the financial crisis and, importantly, what's still continuing today. The main point of the book is that, while there may have been cosmetic-type changes and tweaks around the edges, the core incentives that led to the financial crisis are still in place today. In that regard, nothing has changed.

CR: *And what about earnings estimates? There's a perception that it's easier for an analyst to change his earnings estimates than it is to change his price target or his buy/sell*

recommendations and, therefore, that investors might want to pay more attention to the change in the earnings estimates than to anything else. What's your viewpoint on that?

MM: My viewpoint is that the end user of Wall Street analyst reports needs to understand the source. So, for me, I work at a company, CLSA, where our primary job is advising investors on what to do—as opposed to having potential conflicts when it comes to deal-makers trying to make deals with the companies that I cover, or traders trading all sorts of securities for businesses that don't relate to the core customer. So consider the brokerage firm being used, and then consider the analyst. Is the analyst someone who has a long-term track record, who's objective and trustworthy, at least based upon what the analyst has done in the past? If you're at the point where you have to worry about estimate changes versus price target changes versus rating changes, then you have to ask yourself, why are you even using that source in the first place?

CR: *If someone's going to a broker for the first time and gets a research report for a given stock, is there anything to look for to get a sense of whether or not the analyst is doing a good job, whether he's truly being objective? Or is it more a matter of being able to look at his past history?*

MM: Well, I think investing should be done within the context of a person's individual needs. To the extent that there is a financial adviser helping someone out with the investment experience, I think it's fair game for that person to ask the financial adviser, "What source are you using to help pick my stocks?" But most importantly, the idea of picking a stock and trying to make big money—doing that in isolation is very 1990s-ish. I think we've moved past that. But for the person looking to select a portfolio of stocks as part of an overall investment direction to meet a certain goal, I think it's important that that stock selection is done without conflicts of interest and using some of the best sources.

CR: *In terms of listening to conference calls, obviously, you see things from an insider's*

point of view. When an investor is reading through a conference call transcript, are there any signs that maybe the CEO is putting pressure on analysts or that analysts are afraid to ask certain questions? Is there any way you can tell, as an outsider, that that type of thing is going on?

MM: Very much so. And so much so that I write about it sometimes. Sometimes, when I've gotten beaten up on conference calls, everyone can see that. When a company is acting defensively and attacking me, the biggest mistake that I've made is to take it too personally—especially when I was starting out in the early 1990s. Instead, this reaction by a company has typically served as a red flag that that company has something to hide.

So, one sign is a company acting very defensively. Two, are they not disclosing information that it seems reasonable to disclose? Are they dancing around the answer? Are they addressing the question head-on, or are they simply evading that answer? And that's something else that's very clear. Many of the questions that I've asked on conference calls are very basic ones that were not answered. This includes during the financial crisis. I was referenced in the book "Too Big to Fail," by Andrew Ross Sorkin (Penguin Books, 2011). Lehmann Brothers management said they needed \$7 billion of new money, and they told us how they were going to raise \$3 billion. The big question that I asked was, "Where are you getting the other \$4 billion?" And Sorkin said in his book, "Well, Mike Mayo asked the question that really had management's head spinning." You know how I got that? Three plus four is seven!

So the point is, why isn't management explaining things in very clear terms? Albert Einstein said you should be able to explain physics to a bartender. If that's the case, you should be able to explain finance to a bartender, and to anyone else also.

So when there's a discussion that's so complicated that you can't understand what's going on, it's not your fault. It's the company's fault for not explaining it in very clear and simple terms. Those

Analyzing Bank Stocks

Editor's note: Mike and I also spoke about analyzing bank companies, which have different balance sheet structures than most companies.

CR: *If someone's looking at a bank stock, what do they need to consider that's unique regarding banks that they wouldn't find, say, if they're looking at a manufacturer?*

MM: I think risk management is even more important in banks than in other industries because banks are so levered. Before the crisis, you had some banks levered 20 to 25 times to one. But even after the crisis, with the new capitalization rules, you'll see banks levered eight to 10 times to one. They're still very levered entities.

That means not only ensuring that they have adequate growth prospects but also making sure they know how to manage risk.

So, ultimately, you can't figure out everything that's taking place at a bank. At some level, it does become a black box. You can look at the past performance of the managers, what sort of risk controls they have, did they mess up in the past, why did they mess up, what's the consistency of strategy, and what's the consistency of the management team, individually and working together as part of the team.

CR: *How does an individual investor looking into a bank determine how leveraged the bank is? What, specifically, are they looking for?*

MM: If an individual investor is getting into the weeds that much, and they are not a sophisticated investor, then I think at that point they need to talk to their financial adviser and make sure they have some support for that.

Having said that, the most basic statistic over the years is the ratio of equity to assets, which is the measure of leverage. You can play around with the ratio, but ultimately it's simply how much debt you have relative to your equity. And so, there are many variations of that equity-to-asset figure. There are regulatory definitions like Tier 1 capital. And there are changes to the denominator—instead of assets, it could be risk-weighted assets. So it gets pretty technical—I don't want to say complex; it's simply technical. You have your own language within the banking industry and bank regulation. And you can get a good start on some of those ratios. But it always has to be viewed in context. At some level, a bank that's pursuing super-aggressive loan growth strategies—such as what we saw before the financial crisis—can have a lot of capital, but that's not going to help if the bank's having problems. So always view capital in the context of the risk management abilities of top management.

are red flags for anybody paying attention to the management team.

CR: *So if someone sees something in an earnings release that raises a concern for them, and it's not being asked about or management's not addressing it, that should be a sign of caution for the investor.*

MM: Definitely. But I would go even more basic. Once a year, companies release annual reports, and there's a letter from the CEO. Sometimes it's only about five, six, or seven pages to read. Go ahead and read those five, six or seven pages from the CEO. Do you understand what the CEO is saying? Is the CEO defensive? Is there a clear strategy? I spent last weekend reading those first few pages from the CEO letter to shareholders in about eight different

annual reports from the big banks, which I review. Once you're done reading that, you get a sense about which companies have a clear vision and strategy and metrics to hold them accountable by. Others may seem all over the map.

CR: *And what about the 10-K (annual report) or the 10-Q (quarterly report)? We always tell investors they should read them. Is there anything in particular that you look for when you pull those up? Or are you just looking for anything that seems out of the ordinary?*

MM: I once again stress the annual report more than any other document that you read. Sometimes the 10-Ks and 10-Qs get very complicated for somebody who is not a sophisticated investor. At that point, you may need to rely on professional analysts.

Having said that, changes in accounting policy can be a red flag. And then it simply goes back to what I learned in business school, the EIC approach: The economy—how does that impact the company? The industry—how well is the company positioned within the industry? And the company itself—what's happening with the revenues and expenses and the trajectory of those trends?

CR: *Is there anything I haven't asked you that should be brought up to investors?*

MM: Well, I think, especially for many individual investors looking to save for retirement, it's very important to ensure that you have somebody you can trust. I selected my bank 10 years
(Continued on page 32)

In a recent case, a healthy 79-year-old is on the cusp of having to put up significant collateral and within seven years of the entire program collapsing, which would wipe out his net worth of \$25 million. The cost of terminating such a policy is paying for all the free life insurance clients have had. (The policy is paid for by a loan with the intent that the death benefits will exceed the cost of the loan.) If policyholders don't die soon enough, the program collapses.

Financing of premiums only with interest paid out-of-pocket is a six-of-one-half-dozen-of-another proposition. There may be unique circumstances where this might be desired, but financing premiums *and* interest should never be used.

Deferred Annuity

A deferred annuity is an asset that defers recognizing income until the annuity matures.

A deferred annuity can be continued and transferred to a spouse at death without tax consequences. Ultimately, a

deferred tax annuity can be transferred to children, and they will receive income relative to their life expectancies with the appropriate taxes paid. Contract owners can also exchange the deferred annuity for an income annuity at retirement to receive income for life.

An investor should use deferred annuities to absorb taxable income or otherwise unused cost basis from life insurance policies that are being terminated because tax-neutral exchanges are allowed. I recommend using a fixed annuity instead of a variable or index annuity.

Deferred annuities usually are not an appropriate asset for the wealthy because they have no need to convert to an income annuity, but do need greater flexibility in asset distributions to assist with estate planning strategies.

Income Annuity

An income annuity provides income for life with a specified certain period, say 10 years, if this is desired. (The income can be guaranteed for 10 years.) Usually,

a portion of the income payment is taxable, but the remainder is the tax-free return of principal.

In combination with deferred annuities for early accumulation, income annuities are tax-efficient vehicles that can be used when qualified retirement plans have been maxed out. You cannot outlive annuity income.

For those who are in great health, have family longevity, and who live beyond their estimated life expectancy, income annuities can provide a significant return.

Life Settlements

A life settlement is the sale of a life insurance policy by the policyowner when the insured's health has deteriorated and he is desperate for cash. Other than insureds in this situation, a policy won't sell or shouldn't be sold.

Clients I have assisted with a policy sale have found it quite distasteful, so a life settlement should only be considered when there is no other alternative. ▲

Peter Katt, CFP, LIC, is the sole proprietor of Katt & Co., a fee-only life insurance advising firm located in Kalamazoo, Michigan (269/372-3497); www.peterkatt.com. Find out more about Peter at www.aaii.com/authors/peter-katt.

Stock Strategies

(Continued from page 24)

ago because I just wanted a bank that I could truly trust, more than anything else. If you give up a little bit on the upside, then that's okay, as long as you have somebody you can trust.

And, conversely, if you're getting just a little bit of extra return, no matter where it is, you have to ask yourself: Why am I getting that extra return? Because when you get more return, there's more risk. There's no free lunch. And the biggest mistake people make is chasing the fast buck, thinking they

can get something for nothing, and then finding out about the price they have to pay later on.

And I just want to reiterate one theme from my book about trust: I think the biggest problem with the financial crisis was the overseers getting paid by the companies that they oversaw, a situation that's still in place today. That's true with rating agencies or the accounting firms or the regulators or politicians or Wall Street. While there are all sorts of checks and balances, the checks are skewed in favor of the large companies.

So if we want to fix the system, we need to improve the incentives, which would then result in a better version of capitalism, or a sustainable capitalism.

CR: *And until that point, I guess, an investor should look at the adviser's track record and go with someone who has a good track record?*

MM: If you have to pay a little bit extra, if you have to get a little bit less return, if you have to do a little bit more homework to find the right financial institution or person you are going to rely on, do it—it's worth the effort. ▲

Mike Mayo is a banking and finance analyst with CLSA, a global boutique brokerage firm, and author of the book "Exile on Wall Street: One Analyst's Fight to Save the Big Banks From Themselves" (John Wiley & Sons, 2011). For more information, go to www.aaii.com/authors/mike-mayo. Charles Rotblut, CFA, is a vice president at AAI and editor of the AAI Journal. Find out more about Charles at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/charlesrotblut.
