# A Rare Breed

## Independent Analysts Aren't Perfect, But At Least They're Free To Speak Their Minds. Too Bad Most Retail Stock Investors Are Limited To Brokerage Reports

**Matthew McClearn, Canadian Business Magazine**
Published: Monday March 4, 2002

The Stop 50 Truck Stop just outside Hamilton, Ont., seems an unlikely place to happen upon an equity research analyst. One of many wayside outposts alongside Canada's major highways, it's a haven for the gruff road warriors who haul much of the nation's goods. The burgers at its rustic restaurant are prettytasty, but you won't find Armani-clad brokerage magnates pulling up in their BMWs for a bite. Then again, with his blue denim shirt and crooked nose--broken several times during his years as an amateur hockey player--62-year-old Larry Woods doesn't look like your typical analyst. In fact, he hails from Hamilton, not Bay Street. And he's intensely interested in what goes on at this particular truck stop--so much so that he comes here every second Saturday morning.

It's one of more than 40 unorthodox economic barometers studied by Woods, who runs an outspoken two-man analysis shop. If he's seeing consistently fewer rigs at Stop 50, falling freight rates and poor financial results from major trucking companies, it means "inventory ain't moving, which means inventory ain't selling," he explains. When not frequenting truck stops, Woods picks the brains of bond, gold and microchip traders around the world. And by ham radio, he likes to speak with regular Joes in other countries about recent events within their economies. He also keeps a close eye on consumer debt levels, including bank loans, credit cards, stock-trading margin accounts and home refinancings. He even watches other people's driveways--when one out of every four has a parked trailer or motorcycle for sale, he says, it means people are running into liquidity problems. These barometers may seem "amateurish," he admits, but they work. And they have brought him to an unsettling conclusion: the economy is headed for deep recession. "[US Federal Reserve chairman Alan] Greenspan has shot off all of his ammunition, and he hasn't had much impact," says Woods. "All he's done is delayed the Day of Reckoning." That's seemingly at odds with several recent stock market forecasts. In January, UBS Warburg strategist and chief economist George Vasic predicted that companies in the TSE 300 index will experience 20% earnings growth this year. That same month, analysts tracked by Boston-based financial research firm Thomson Financial/First Call predicted that profits of S&P 500 companies should rise 16% in 2002. Woods couldn't agree less. "OK, boys, if you're predicting [16% to 20%] profits, how come companies are laying off people?" he argues. "You don't lay off when you're expecting to move from losses to profits. That's bullshit!"

When conducting contract research on specific companies, Woods' methods are equally unconventional. He's been racking up more than 100,000 kilometres a year on his Volkswagen Golf meeting with salesmen, distributors, engineers and other sources across North America, scrutinizing the sales channel from the bottom up. And though he's not an accountant, he likes to study the books closely. The two people he won't speak to are the CEO and chief financial officer. "Most execs in most companies are either very optimistic or they lie through their teeth," he explains.

Woods' remarkable candor is unusual, but don't chalk that up entirely to his blunt personality. Unlike the analysts you're probably most familiar with, he doesn't work for a brokerage. He's independent. That word is gaining currency in the investment research business in the aftermath of the biggest bull run in history. In Canada alone, the massive 1997 fraud scandal at Bre-X Minerals Ltd., last year's Nortel Networks Corp. stock implosion, and the controversial bullish

research of Yorkton Securities Inc. (which contributed to the firing of CEO Scott Paterson and heavy fines levied against the firm and some employees by the Ontario Securities Commission late last year) all had investors wondering why analysts didn't warn them earlier. In the US, the infamously exuberant forecasts on dot-coms by Morgan Stanley's Mary Meeker and Merrill Lynch & Co.'s Henry Blodget have become the stuff of Wall Street legend. And after Enron Corp.'s recent collapse, some analysts admitted that they never understood the company's enigmatic financial statements. Why did analysts fail their clients? The answer may have a lot to do with their lack of independence.

Most sell-side analysts (who work for brokerages that sell stock, as opposed to buy-side analysts who work for mutual funds and other institutions that purchase securities for customer portfolios) face potentially serious conflicts of interest when issuing research reports. The reason is simple: while a report's ostensible purpose is to provide independent, objective advice to clients, the firm's raison d'être is something quite different. The Securities Industry Committee on Analyst Standards (SICAS)--formed by the Toronto Stock Exchange, Canadian Venture Exchange and Investment Dealers Association of Canada in 1999--said in its final report last November that analysts earn revenue for their firms by providing investment ideas for their clients (who in turn trade stock on that information, generating commissions) and by helping secure investment banking transactions. The profit margins from commissions are much thinner than those from investment banking. To win the latter, an analyst must have a good relationship with the companies she covers--and typically, a large portion of her compensation is tied to roping in big deals. "It is clear that the role of sell-side analysts in promoting the firm has increased substantially," the report noted. "This has heightened the potential for conflicts [of interest]."

It doesn't stop there. Some analysts own shares in the companies they cover, tying their own fortunes to upward stock movement. And while the market for a sell report is largely confined to current shareholders or short-sellers, buy recommendations appeal to a larger market. To top it off, a negative report often alienates the company and its shareholders, which can result in the analyst being shunned or even sued. Add it up, and one is left to wonder why an analyst would ever advise clients to sell the stock of a troubled or poorly managed company.

Answer: they rarely do. Of the 24,750 stock recommendations recently tracked by First Call, 62.6% of them are buys or strong buys, 35.6% are holds, and just 1.8% are sells or strong sells. According to First Call equity research analyst Tom O'Keefe, that's the most sells on record. "Things are becoming a little more honest," he says, "but recommendations tend to be overly optimistic, as you can tell." In "analyst speak," a hold rating often denotes something very different than its plain-English meaning. Even a confusing but seemingly innocuous long-term outperform may actually be a harbinger of impending doom. When a company has really hit the wall, analysts routinely terminate coverage, leaving investors to read between the lines.

Though analysts arguably face more threats to their objectivity than ever before, it's not a new problem. As a partial stopgap, most brokerages have built a Chinese Wall, an imaginary barrier preventing the marauding barbarians in investment banking from invading the sacrosanct research department. This practice, instituted by the US government to restore investor confidence after the stock market crash of 1929, separates the two departments in various ways--among them, many brokerages locate the departments in different places.

But even in top-rated brokerages like RBC Capital Markets, the wall has cracks. "I really try to be objective, which is difficult in our industry because of the amount of money we make from investment banking and underwriting," admits Maureen Howe, a plain-talking pipelines, gas and electric utilities analyst at RBC in Vancouver. "There have been times when I've come under severe pressure.... I've had some very nasty calls from senior people in the firm [following negative research reports]." Howe says she compensates by backing negative calls with incontrovertible evidence. But not all analysts have been so circumspect. And in some firms, the wall has been breached. In a 2001 memo, for example, an executive with J.P. Morgan Chase &

Co. instructed European analysts to notify both investment bankers and the companies concerned before changing stock recommendations.

The status quo is so problematic, even Woods is sympathetic. "I used to rage at some of these analysts out of New York, but I don't do it anymore," he says, "because I've learned about some of the things these guys have to put up with. One guy told me, 'I'm sick of you harping in my ear. You sit up there in Hamilton, you don't have anyone to answer to. I make a million bucks a year, you think I'm going to turn it down and start issuing 'sell' ratings? They'd fire me in a nanosecond.'"

With investors skeptical about the integrity of the Chinese Wall, the brokerage industry is looking at new solutions. The Association for Investment Management and Research (AIMR), an international organization of investment professionals based in Charlottesville, Va., is one of several groups that believe disclosure offers a partial remedy. It's calling on brokerages to prominently reveal in research reports any relationships between themselves and the subject company, be it an analyst holding shares or a firm's recent underwriting work. While such an approach does uncover potential conflicts, it does little to free analysts from pressure. There are other solutions also under consideration--for example, Merrill Lynch and Edward Jones have prohibited their analysts from holding stock in the companies they cover. But, as the SICAS report noted, some in the brokerage industry fear regulation: "Care should be taken in mandating research standards, as budgets will be reduced if research does not give a firm competitive advantage."

Isn't the best solution simply to free analysts from their conflicts altogether? Michael Palmer thought so. A research veteran of more than 20 years, Palmer resigned from Toronto-based First Associates Investments Inc. to cofound **Veritas Investment Research Corp**. (initially called Private Financial Research Corp.) in 2000. "There was nobody else doing [independent research], so we felt that it was an unserved market," he says. "We thought that we could do some good, get capital allocated more efficiently—and even make a living doing it." Chaired by forensic accountant Al Rosen (a columnist for Canadian Business), **Veritas** has five analysts with a distinct accounting bent. The firm has no investment banking arm or trading operations. Its clients trade shares through Commission Direct Inc. (CDI), a Toronto brokerage firm, which pays **Veritas** 80% of the commissions on trades executed by **Veritas** clients. **Veritas**'s analysts are prohibited from trading shares in a company for 30 days before and after they issue a report on it. "I don't know if you would call us misfits," says Palmer, "but certainly we're different."

There are also marked contrasts between the buy rating pumped out by brokerage analysts and the research produced by independent shops. In testimony before the US Committee on Financial Services last year, independent US analyst David Tice (whose company publishes an institutional research service called Behind the Numbers) stacked his research against Wall Street's on Paging Network Inc., Sunbeam Corp. and Rhythms NetConnections Inc.--three firms that went bankrupt in recent years. "Though there was ample evidence of these firms' financial difficulties, Wall Street either minimized, dismissed or ignored such information in their reports," he alleged.

Back when Woods authored The Tech Review newsletter in the late 1990s, he was highly critical of dotcoms. And **Veritas**'s feisty, often sarcastic research reports decry the accounting shenanigans employed by some of the companies they cover. Take, for example, a report authored by **Anthony Scilipoti** last June on Nortel (TSE: NT). "To us, the company's actions suggest that it is scrambling for cash," **Scilipoti** wrote. "We have long opined that Nortel's stock was overvalued, largely because the company had done a brilliant job of steering the market away from its operating losses and its negative operating cash flows." In the ensuing examination of Nortel's cash flow, he concluded that the outlook was bleak. A few months later, in a report on Sleeman Breweries Ltd. (TSE: ALE), Palmer blasted the company for high debt levels and some of its accounting methods.

As with all **Veritas** reports, neither offered a recommendation or a target price. "I'm not sure when analysts are going to realize that targets are pie-in-the-sky," **Scilipoti** says. "We say, 'Listen, if you're going to own this stock, these are some things you should know about.' They may not impact the stock for one, two or five years--until the cash runs out, until the transactions and side deals that management is doing totally fall apart." However, **Scilipoti** won't be explaining the shortcomings of price targets to brokerages, because he doesn't fraternize with the analyst crowd. His downtown office may be a stone's throw from Bay Street, but in terms of ideology, he's light years away. Independent analysts could go a long way toward providing investors with the bad news they need to hear. But as AIMR president Thomas Bowman noted last year, "analysts are not infallible, even when independent and objective." Last year, the independence of "independent" Silicon Valley analyst Steve Harmon was questioned when it was revealed that--among other things--he solicited money for his own US$50-million venture fund from CEOs while talking up their stocks.

And then there's Woods himself. Back in 1986, he was a director of Plastic Engine Technology Corp., which was then struggling to complete an $11-million financing. According to Woods, one potential backer had demanded that James Richardson, a former Liberal defence minister, convert the $500,000 he held in Plastic Engine debt into equity. Richardson was reluctant. In efforts to complete the financing, Woods says he suggested that Richardson short-sell an equal amount of stock so as to neutralize the risk. Richardson agreed. But weeks later, the financing fell through, and Plastic Engine collapsed. The OSC accused Woods of insider trading, "tipping" and issuing a misleading press release. Richardson, who was accused of illegal short-selling, paid a substantial settlement to the OSC (without admitting guilt), but Woods opted to fight the charges. After a protracted court battle that nearly pushed him into bankruptcy, he was cleared of the other two charges but found guilty of insider trading and fined $15,000. On appeal in 1995, the charges held, the fine was dropped, and he was sentenced to 90 days in jail (served mostly through community service on weekends). Woods still insists that he did nothing wrong. He says he has accumulated new evidence, and plans to return to court to vindicate himself. Independents are not immune to conflicts: some, for instance, trade stock in the companies they cover. And they, too, face consequences for issuing negative reports. "There are a lot of sleepless nights on our end," **Scilipoti** says. "We've been barred from analyst meetings. We've been threatened with legal action." Disgruntled companies have even filed complaints about **Veritas** with the OSC, the Securities Exchange Commission and the Institute of Chartered Accountants of Ontario. But in spite of that, **Veritas** continues to print unpopular opinions. "We're sticking our necks out for clients," he claims. "No one else is willing to do that."

**Veritas** is hopeful that its modest success will encourage others to open independent research shops. "The Enron scandal, our expertise in accounting and our independence have really added to our cachet recently," says Palmer. "With corporate finance revenues falling off and with us having proved the business model, I would not be surprised if more firms like ours were created." But this may be a rare example of Palmer being too optimistic. In Canada, independent research firms are nearly as rare as palm trees in Labrador--and there aren't too many in the US, either. The unfortunate reality is that most independents--Woods and **Veritas** included--exclusively serve institutional investors, not the small retail investor who's the biggest loser in the biased research racket. "No-body's figured out a way to deliver it profitably to them," Palmer concedes. What are the chances Bay Street analysts will sacrifice profits to become as free and outspoken as Larry Woods? Probably the same odds as them joining him next Saturday morning at Stop 50.