

**Seeing through the Seers of Wall Street:  
Analysts' Career Concerns and Biased Forecasts**

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One of the hallmarks of the US stock market is its transparency. Unlike their counterparts in some other countries, companies here are supposed to accurately report public balance sheets and a wide array of other information that investors can then use to assess the rewards and risks of their investments. This transparency is generally credited with helping to attract international investors, which boosts stocks prices and lowers the cost of capital for US companies. But with the recent revelations of accounting fraud at major companies like Enron and WorldCom, investor confidence in the US stock market has been deeply shaken. As evidence of this crisis in confidence, there are a myriad Congressional inquiries underway to investigate the corporate malfeasance and related Wall Street excesses that occurred during the stock market bubble of the late nineties.

An important part of this scrutiny is aimed at sell-side security analysts, the personable prognosticators on television shows like CNBC that offered predictions and recommendations on stocks. Just as companies are supposed to truthfully disclose information, many, particularly individual investors, thought that the earnings forecasts and stock recommendations made by these analysts would be somewhat objective. However, when well-known analysts such as Mary Meeker, Henry Blodget and Jack Grubman continued to be cheerleaders for dot-com and telecom stocks even as their once-sky high valuations collapsed, the objectivity of sell-side analysts was called into

question. The Congressional hearings underway are seeking reforms to protect naïve individual investors who lost money as a result of these overly-optimistic recommendations.

A fundamental question that these hearings are attempting to address is why analysts issued such wildly biased forecasts? There are three possible answers to this question. The first is career concerns or conflicts of interest---analysts are rewarded for biased forecasts by their employers (brokerage houses) who want them to hype stocks so that the brokerage house can garner trading commissions and win underwriting deals. The second is selection bias--analysts only follow stocks that they recommend and do not issue forecasts on those that they do not like. The third is cognitive or behavioral bias---analysts become too attached to the companies that they cover and lose objectivity.

Not surprisingly, lawmakers are pre-disposed toward the first explanation, while brokerage houses and their analysts favor the latter two. More broadly, these hearings bring to the foreground the issue of whether sell-side analysts are paid to be objective as brokerage houses claim or to hype stocks? Understanding security analysts' career concerns or incentives and their role of in the financial system is needed before lawmakers can enact any reforms.

Once relegated to producing boring reports on stocks in the backrooms of brokerages, security analysts became an integral part of Wall Street profit centers over the last decade. Through media outlets such as CNBC, they reach millions of individual investors. At the same time, investment bankers rely on them to help land investment-banking deals. As a testament to the growing importance of analysts, CEOs report in surveys that the reputation of a brokerage house's analyst covering the industry that the

company is in is an important determinant of their choice of an underwriter for their initial public and seasoned equity offerings. Analysts who are influential among institutional buyers such as mutual fund managers can also generate hefty trading commissions for their brokerages.

Unfortunately, the growing importance of analysts in a brokerage house's investment banking and trading businesses appears to have deeply compromised their objectivity. A number of studies have found that analyst forecasts, earnings projections and stock recommendations, are optimistically biased and became even more so during the stock market bubble of the late nineties.<sup>1</sup> Importantly, studies also find that an analyst from a brokerage house that has an underwriting relationship with a stock tends to issue more positive predictions than analysts from non-affiliated houses.<sup>2</sup> These findings suggest but do not definitively prove that analysts' biased forecasts are due to their career concerns or conflicts of interest as opposed to the other explanations such as selection or cognitive biases.

However, anecdotal evidence indicates that such allegations have merit. Congressional inquiries reveal that internal memos at Merrill Lynch, the largest brokerage house in the country, quoted sell-side analysts as saying that they were peddling stocks that they knew to be losers to an unsuspecting public. Moreover, analysts who do not go along with optimistic projections (often made by the management of companies) are reportedly passed over by their brokerage houses in favor of analysts

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<sup>1</sup> See Stickel, Scott E., 1990, Predicting individual analyst earnings forecasts, *Journal of Accounting Research* 28, 409-417; or Dreman, David, and Michael Berry, 1995, Analyst forecasting errors and their implications for security analysis, *Financial Analysts Journal* 51, 30-42.

<sup>2</sup> See Lin, Hsiou-wei, and Maureen F. McNichols, 1998, Underwriting relationships, analysts' earnings forecasts and investment recommendations, *Journal of Accounting and Economics* 25, 101-127; or Michaely, Roni, and Kent L. Womack, 1999, Conflict of interest and the credibility of underwriter analyst recommendations, *Review of Financial Studies* 12, 653-686.

who do.<sup>3</sup> An oft-cited example during the nineties is the departure of Jonathan Cohen and the subsequent hiring of Henry Blodget by Merrill Lynch. Cohen, more “old school” in his forecasts of technology stocks, used valuation models and was unable to go along with the numbers given by management. In contrast, Blodget, a history major without any background in business other than experience as a reporter for CNN Business news, was happy to follow managements’ optimistic projections. Indeed, even after the collapse of the dot-com stocks that Blodget championed, Merrill Lynch assigned him to cover Microsoft, a highly coveted assignment.

Recent research by myself and Jeffrey Kubik of Syracuse University finds that analysts are systematically rewarded for being optimistic.<sup>4</sup> As the example of the hiring of Blodget and firing of Cohen by Merrill Lynch makes clear, not all analysts are able to be cheerleaders for stocks depending on their moral concerns or aptitude. So an interesting question is whether those that are optimistic are rewarded with better jobs or assignments? To answer this question, we study the brokerage house employment and earnings forecast histories of roughly 12,000 analysts working for 600 brokerage houses between the years of 1983 and 2000. We find evidence that analysts are indeed systematically rewarded for being optimistic as long as the optimism is within a range of accuracy that maintains the credibility of analysts. Analysts who are relatively more optimistic compared to their peers are much less likely to be fired by or to leave a top brokerage house, and much more likely to be hired by a better house. They are also given better assignment such as covering large and well-known stocks like Microsoft.

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<sup>3</sup> See Cole, Benjamin M., 2001, *The Pied Pipers of Wall Street: How Analysts Sell You Down the River*, (Bloomberg Press, Princeton, NJ); and Hansell, Saul, 2001, As tech stocks fall, some analysts prosper, *New York Times*, Online Edition, March 4.

For analysts who cover stocks that are underwritten by their brokerage houses, we find that the dependence of their career prospects on forecast accuracy is significantly attenuated. In other words, analysts are judged less on accuracy when it comes to stocks underwritten by their houses. This finding is a novel piece of evidence supporting the conflict of interest allegation regarding analysts covering stocks affiliated with their brokerage houses. Interestingly, the dependence of career prospects on forecast optimism is also significantly larger for these analysts.

Importantly, we also find that accuracy mattered much less for career concerns in the 1996 to 2000 period than in earlier years, while forecast optimism mattered much more. So, it appears that brokerage houses threw whatever concern they had for objectivity in their research out the window in the midst of the stock market mania of the late 1990s as the job description for being an analyst became more tied than ever to promoting stocks.

In sum, brokerage houses apparently value analysts that are optimistic presumably because they help promote stocks and hence generate investment banking business and trading commissions. Moreover, the weight of the evidence strongly indicates that analysts' career concerns and conflicts of interests are the most likely reason behind their wildly optimistic forecasts during the stock market bubble.

Our findings also offer some guidance for policy, as current Congressional hearings are debating whether and what types of regulations to impose on brokerage houses. Since analysts are rewarded for promoting stocks generally and not just for stocks underwritten by brokerage houses, the current attention on underwriting

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<sup>4</sup> See Hong, Harrison and Jeffrey D. Kubik, 2002, Analyzing the analysts: Career concerns and biased earnings forecasts, *Journal of Finance*, forthcoming.

relationships as the sole conflict of interest may be too narrow. Also, the post-Enron outcry to regulate explicit incentives such as having security analysts disclose which stocks they are buying for their personal portfolios is also too narrow. Our findings indicate that implicit incentives such as analyst's reputation, hiring and firing patterns and allocation of assignments are equally if not more important in affecting analyst behavior. Unfortunately, it is much more difficult to regulate such implicit incentives. Rather, some form of public education or warning to investors to be alert to the recommendations of certain analysts may be more helpful. But at the end of the day, investors ultimately need to see through the seers of Wall Street!