REUTERS

LIFTING THE LID: Paid-for stock research scores with investors

Thu July 15, 2004 01:37 PM ET

By Ritu Kalra

NEW YORK, July 15 (Reuters) - Stock research commissioned by listed companies has traditionally gotten little respect.

Institutional investors saw it as the bottom of the food chain, even below the Internet-era reports peddled by brokerage firms that regulators showed were tainted by ties to investment banking business.

Lately, however, portfolio managers are overcoming their skepticism. They cite impressive performance and access to information on companies that the large Wall Street investment banks don't bother covering.

Although questions of objectivity and the potential for stock scams remain, experts say some of the research is on par with the best -- and takes an independent line no matter who paid for it.

Taglich Brothers and J.M. Dutton & Associates, which both get paid by the companies they write about, were among the top five equity research firms last year, according to Investars, a Hoboken, New Jersey, firm that tracks the performance of analysts' stock picks.

"I'm more apt to look at a Taglich report than I am a major firm," said Evan Greenberg, who manages about $30 million at New York-based Meadowbrook Capital Management. "They're one of the best-performing brokerages I work with."

StarMine, a San Francisco-based performance tracker, gives two of Dutton's 18 U.S. analysts five stars for their stock picks over the last two years, a designation reserved for the top 10 percent of analysts.

Investors who followed the advice of energy analyst Les Childress, for example, got a 64 percent return, nearly 23 percentage points above the average return on the companies he covers.

LACK OF COVERAGE

Without Childress' direction, investors would have been hard pressed to find those companies. As Wall Street firms cut analysts' ties with their investment banking operations and struggle to support the high costs of research with trading commissions alone, they have pruned the number of companies they cover to the biggest names.

For companies whose market capitalization is less than $500 million, overall coverage is down by more than 35 percent since 2001, according to research firm Thomson First Call. And nearly 60 percent of all publicly traded companies in the United States get no coverage at all.

This severely hinders smaller companies' ability to attract capital, experts say.

In response to the drop in coverage, many small companies have sponsored their own reports. For $25,000 to $40,000 a year, they get third-party earnings estimates and stock ratings that are distributed on their Web sites, through broker-dealers, and on platforms such as Reuters Estimates, Thomson First Call and Yahoo Finance.

The opinions aren't always glowing, as evidenced by Fundamental Research Corp's downgrade on June 9 of technology company Resin Systems Inc. (RSSYF.OB: Quote, Profile, Research) (RS.V: Quote, Profile, Research) to "hold" from "buy" due to production delays.

"You're not buying the research to make your company look better than what it is," said Resin Chief Executive Greg Pendura. "You're simply going the awareness route. For small companies, it's very difficult to attract institutional attention."

Investors are listening. In May, more than 200 institutions, including Merrill Lynch Investment Management and BlackRock Advisors, downloaded Dutton's reports from Thomson First Call.

Meanwhile, New York-based Crystal Research Associates, which focuses on the health care industry, said it distributes its reports to more than 5,000 investors each month.

"If a company's looking for research coverage, usually there's a good story to tell, and it's not being told anywhere else," says Meadowbrook's Greenberg. "I need this model."

CAVEAT EMPTOR

Strange as it may seem, sponsored research is considered independent because it has no ties to investment banking. And unless the research firm also happens to be a registered broker-dealer, as Taglich Brothers is, it is largely unregulated.

"This is obviously fraught with all kinds of conflicts of interest," says Jonathan Boersma, vice president of professional standards at trade association CFA, formerly the Association for Investment Management and Research.

His organization has proposed guidelines to help the nascent industry police itself. To ensure objectivity, research firms should be paid upfront in cash, and companies should have no influence on the content of the reports, Boersma says.

Although those guidelines are not enforceable, the research firms do have to comply with SEC rule 17(b), which requires them to disclose their form of compensation to investors.

But concerns about the company-sponsored model remain.

"I think the desire for repeat business will cause many analysts to butter up their clients" with inflated forecasts and ratings, said John Coffee, a professor of securities law at Columbia University. "The disclosures don't end the real basic conflict, which is that you want future business."

To that fear, investors have one response: performance.

"You can only fool the buy-side once," says Adam Epstein, portfolio manager at San Francisco-based investment fund Enable Growth Partners. "Our job is to focus on substance, not form, no matter where that substance comes from."