Equity Research Market Failure

Conflicts can cost

EQUITY RESEARCH MARKET FAILURE: CONFLICTS CAN COST

An Industry Investment Thesis

- Over 90% of all research published is by conflicted businesses. Only 10% of recommendations are Sell.
- But even in rising markets, stocks go down as well as up. We estimate over 40% of stocks usually go down over 1-2 year periods.
- The distribution of recommendations has little correlation to market experience in the long run.
- Conflicts impact the character of research, not just the recommendation.

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The Curious Case of Sell Recommendations

Over 90% of all research published globally by the sell side and read by the buy side is produced by banks and brokers with conflicted business models.

We think we can convince you fairly quickly why commercial reality means most equity research could be considered unreliable.

- Between 1983 and 2008 in the US, 64% of stocks underperformed the Russell 3000. 40% of stocks had a negative return despite the index returning around 10% p.a.
- Academic studies show that over the long term, the majority of single stocks underperform the index.

And yet:

- Across a sample of banks and brokers covering European stocks, the average number of stocks with a sell recommendation is around 10%.
- On stocks where the sell side provider has a commercial relationship, this average falls further. In fact, we discovered that multiple providers have

zero sell recommendations on their own corporate clients, despite broad stock coverage and depth.

Two questions at this point may cause you to conclude the model is therefore not fit for purpose.

- If, on average, more than 50% of stocks underperform the index and 40% have negative returns over the long run, what percentage of stocks should have a sell recommendation?
- Why do you think stocks covered by investment banks and brokers have such a low percentage of sell recommendations?

We believe generic coverage simply isn't enough and research houses need to search for ideas with flexibility and prioritise finding, and effectively covering, the stocks that matter for clients.

Exhibit 1: Conflicted Sell Side Models Have 10% Sell Recommendations

				Overall				Own Clients		
	Coverage	Buy or Sell	Retained corporates	Buy	Hold	Sell	% on clients	Buy	Hold	Sell
Broker 1	1200	800	230	69%	30%	1%	19%	89%	11%	0%
Broker 2	200	170	160	81%	16%	3%	79%	98%	3%	0%
Broker 3	3500	2200	1600	48%	39%	14%	46%	38%	35%	27%
Broker 4	3500	2200	300	54%	36%	10%	9%	56%	36%	8%
Broker 5	1800	1100	400	49%	36%	14%	21%	46%	41%	14%
Broker 6	3800	2000	800	38%	46%	15%	16%	44%	53%	3%
AVERAGE				56%	34%	10%		62%	30%	9%
The Analyst	60	60	0	47%	n/a	53%	0%	n/a	n/a	n/a

Source: Investment Bank websites and research disclosures, The Analyst research site, numbers rounded for anonymity

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Obviously, investment banks will argue that the market usually goes up, most stocks go up, and that their own recommendations are not even absolute, but relative.

They may also say the investment time horizon of the recommendation is shorter than our longer term market data set. We don't buy it.

One argument is around the semantics of a buy or sell recommendation at the point the decision is made. What even is a sell? Usually, conflicted broker recommendation choices come in three flavours of anticipated performance:

- The stock could go up, or down, absolutely with a hurdle (e.g. 10-15%).
- The stock could go up, or down, relative to the market.
- The stock could go up, or down, relative to the sector in which it operates.

Any relative recommendations are easy to take to task; the reason most stocks underperform the market longer-term is due to the survival of the fittest and the impact on market cap weighted indices and benchmarks of the big winners.

An amateur statistician might say there is a long, and fat, tail of bad returns. This means with survivorship bias the worst performing stocks shrink, leaving the index to consolidate. For relative recommendations across cycles there should therefore be more sell recommendations than buys.

In our sample above (exhibit 1), the providers using the absolute hurdle have the lowest % of sell recommendations.

Of course, if the market goes up, most stocks should go up – but do they?

We looked at the rolling one and two-year returns (weekly) over the decade up to July 2024 to see how the distribution of single stock returns looked for European stocks (market cap >€1 billion). This is a period when the Stoxx Europe 600 returned ~57% (Source: Factset).

We found on average, for each rolling time period, around half of stocks underperformed the index, and >40% of stocks lost investors money in absolute terms.

Staggeringly, we found that at some point within each two-year time horizon, on average ~15% of all stocks don't just fall in absolute terms – they at least HALVE! (Source: Factset).

Exhibit 2: Rolling 1 and 2yr Time Periods Between 2014-2024 Show >40% of Stocks Delivering a Negative Return in Europe

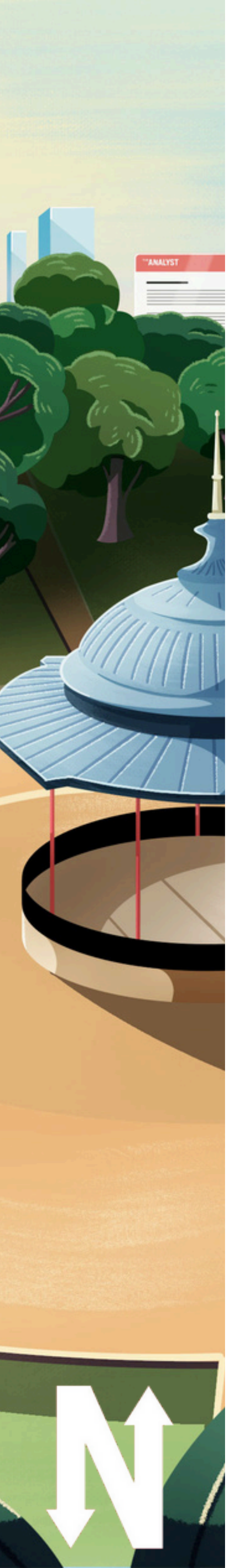
	1yr Rolling Window	2yr Rolling Window
Positive alpha	53%	51%
Negative alpha	47%	49%
Positive absolute return	56%	58%
Negative absolute return	44%	42%

	Mean	Median
Doubling within 2yrs	9.3%	7.1%
Halving within 2yrs	14.5%	12.4%

Source: Factset

The next argument back from our competitors will be that they believe the stock market is going up and in these conditions the mix of recommendations makes sense – why have many sell recommendations if you think it's a bull market? They may layer on more arguments that sector and factor reasons near-term should make stocks go up.

The problem here is that the low percentage of sell recommendations has existed for over two decades. To



us, this debunks any argument that the sell side recommendation mix is appropriate, or even fit for purpose, relative to the anticipated distribution of single stock returns.

The further argument may be that the sell side only covers stocks they think will outperform and obviously they don't cover any expected underperformers. This might be true to start with, but as the total coverage count increases the argument gets harder to believe. We know coverage breadth (number of stocks covered) is a main feature of the low priced offers being marketed by investment banks' research houses today. In our experience, breadth is one of the most common selling points from conflicted providers to the institutional buy side.

The anonymous European broker in our table above managed to conjure up just 1% sell recommendations on c.800 covered stocks.

If we agree the distribution of recommendations over time should resemble the anticipated distribution of returns, but doesn't, then what does it actually resemble? Certainly not a functioning market grounded in logic that

legitimately uses recommendations to try and help its clients.

It simply looks like a list of the percentage of firms that the conflicted sell side would like as corporate clients.

Any research industry trying to help its buy side clients make money through recommendations should simply have a distribution of buys and sells that, over time, and across market cycles, resembles the average distribution of single stock returns. When the market has risen a lot, or is expensive on a cross-cycle basis, or when strategists of banks are negative, surely the mix should shift towards sell, and vice versa.

We understand why the investment banks don’t make Short recommendations, but surely, in our view, a few sells to reflect reality must be available.

Underwriting conditions should ease towards the end of a market cycle, which means the percentage of sells, even on banks’ own clients, should rise. There is no evidence of this, and only independents can possibly and appropriately vary the mix of buys and sells based on business models aligned to clients’ interests.

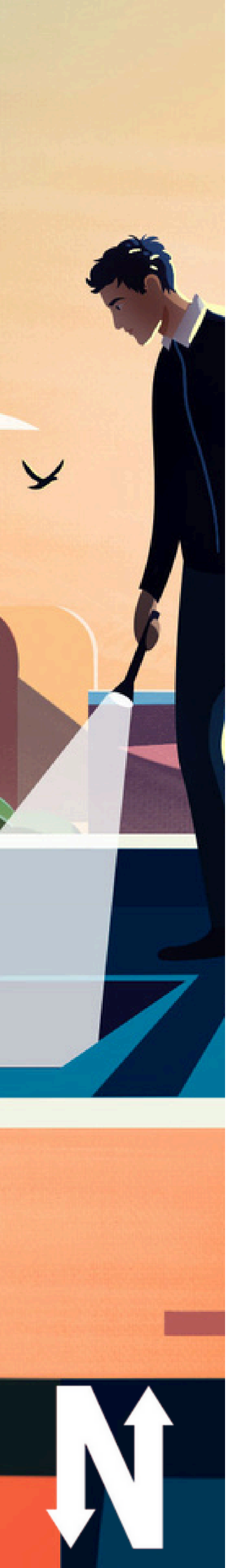
Exhibit 3: Distribution against Market of Independent Buy and Sell Recommendations from The Analyst Over Time

Our ratings distribution as of 12 July 2024:

Rating	Percentage of total recommendations
Strong Buy	24%
Buy	21%
Short	55%

Source: The Analyst research

Conflicted research models not only impact the distribution of recommendations, but the character, tone and content, of research conducted and the notes themselves. Over and over again, corporate governance red flags, unusual accounting, related-party transactions, and/or deteriorating financial performance, go unnoticed and unexamined. Both in IPO research and in any research by sell siders with corporate relationships.



The buy side has to rely on the conflicted sell side to help them on these stocks but they are left unaware of obvious governance risks in a prospectus.

What we are describing above may not be news to market participants – of course the buy side cynically understand the conflicts of their sell side providers.

Of course they know their banks have corporate relationships, and of course they know corporates are using the stock market to raise capital.

Before you call us naïve though, permit an independent firm to dwell on that character of research a little longer with some further questions:

- Are your sell side providers looking at accounting red flags?
- When you have an accounting question, do you get a balanced view, or a repetition of the corporate's explanation?
- Who is reading the last 50 pages of the IPO prospectus for you?
- Does corporate governance matter?
- Does cash flow matter, or is it just about the quarterly earnings?

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- Would a corporate client permit a negative piece of research?
- Do the sell side independently check on facilities, stores, and factories, or are they escorted by management?
- Are 90%+ of companies fantastic with stock prices set to go up?

This isn't about short selling, its simply about the fact that stocks can go down as well as up.

Don't take our word for it...

You can do this research yourself. For many banks and brokers, if you go onto the equities pages and dig through the legal tabs at the bottom you will find the disclaimer pages for their stocks under coverage. On it you will find the mix of recommendations and the variation in recommendations depending on if the research provider has a relationship or not.

THE ANALYST

We are an independent research house based in London. We deliver high impact equity research to some of the world's leading institutional investors.

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