

Please, Proceed to the Nearest Exit – Part 1

by Doug Wakefield with Ben Hill

Today, as I write this article, a financial storm continues to build. Still, most people don't want to be bothered with the details. With such pretty pie charts predicting fair winds, they feel secure aboard the "USS Stocks for the Long Term," chanting the "Buy-n-Hold" mantra should they ever feel a tinge of concern. Yet, when this modern marvel collides with the iceberg of science and history, the pain will cause them to begin searching for what went wrong. Understandably, they want their lives to go as normal. Unfortunately, the thinly disguised marketing materials most investors (and advisors) look to for guidance carry a heavy consequence which will affect many for the rest of their lives.

"Please, Proceed to the Nearest Exit," will be a short series of articles, which will show that to "buy and hold" without an exit strategy is dangerous, reckless, and naive. This series should also make it very apparent that the "money game" is not a gentlemen's sport. In reality, it is more like engaging in hand-to-hand combat. If you doubt this and don't understand how dirty the money game is yet, just save this article and read it again later. The bear is once again rap tap tapping on our chamber door.

But first, I must diffuse the "few bad apples" argument. In his book, [The Pied Pipers of Wall Street: How Analysts Sell You Down the River](#), Benjamin Mark Cole notes that when it comes to Wall Street Analysts' recommendations, the word "sell" is rarely, if ever, heard.

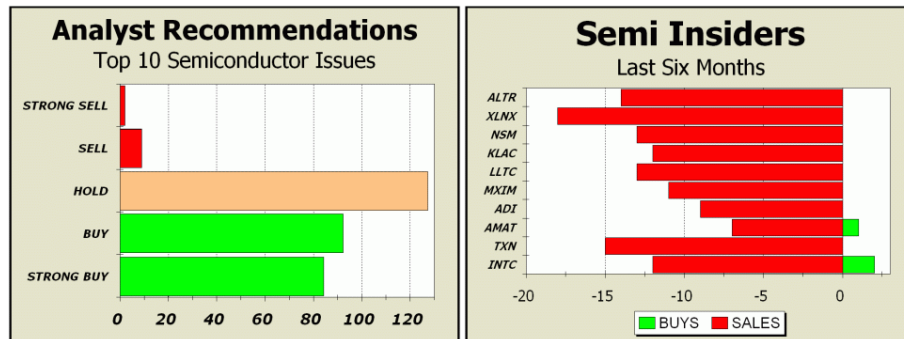
"Of 33,169 'buy,' 'sell,' and 'hold' recommendations made by brokerage analysts in 1999, only 125 were pure sells. That means just 0.3 percent of recommendations were 'sells,' according to data put together by Zacks Investment Research. There were another 224 recommendations, or 0.7 percent, that could be interpreted as 'sells,' such as rankings with such tepid language as 'market underperformer.'" ¹

Or, consider the following. Originally from a 2002 copy of *The Journal of Psychology and Financial Markets*, we showed the chart below in our industry research paper, "Riders on the Storm: Short Selling in Contrary Winds." ²

Year	Buy and Hold	Sell	Total Calls
1996	96%	4%	29,734
1997	97%	3%	30,350
1998	98%	2%	35,445
1999	97%	3%	37,318
2000	98%	2%	32,633
Average & Total	97.2%	2.8%	165,480

If you're thinking, "Yeah, but surely this all changed after the Crash of 2000 (to 2002)," that'd be understandable. From 2000 to 2002, the SP500 lost 50 percent, the NASDAQ lost over 75 percent, and the Dow lost about 35 percent. Still, these two charts, produced in September of 2005 in Alan Newman's [Stock Market Crosscurrents](#), show that while

insiders sold 6.7 million shares and bought 7520 shares (a ratio of 929 to 1) analysts' sell recommendations came in at only 4 percent.³



So why would analysts issue so many buy and hold recommendations and so few sell recommendations while industry insiders flee their own companies' stocks? Two words...

Investment Banking

In May of 1975, Wall Street said goodbye to fixed commission rates, regulated by the New York Stock Exchange, and said hello to the competition. And of course, this had an unintended effect. You see, while investors won the battle to transact at lower costs, they lost the war on solid research.

Dr. Stephen Koffler reveals the pre-1975 environment he worked in as an analyst covering the aerospace industry.

“We put out two-inch-thick binders on different industries, which we would work months and months to produce. People who bought our reports paid us, so to speak, by trading through us. There was enough profit in that to support an entire research firm.”⁴

Consider this. In 1967, retail commission accounted for 57 percent of Merrill's total revenues. Investment banking fees were less than a tenth of that amount.⁵ While the total amount paid in commission grew with increased retail participation in the markets, the total percent declined drastically. A 1997 study by the Securities Industry Association (SIA) revealed that in the 1960s, when the commissions were fixed, they amounted to approximately 60 percent of the industry's revenues. By 1997, commissions comprised only 16 percent of revenues.⁶

But, Wall Street wasn't about to lose out on the deal. Though Wall Street widened the spread (between the bid and the ask) and pocketed it to make up for lost commission revenue,⁷ they also found their way into the lucrative world of investment banking.

“As commission revenues have relatively dropped, brokerage underwriting of stock and bond issues (and attendant revenues) hasn't just shot through the roof;

it's rocketed through the solar system and into deep space. In the 1960s, the brokerage industry underwrote a little more than \$100 billion of stocks and bonds. In the 1990s, the brokerage industry underwrote \$700 billion to \$2.23 trillion *annually*, according to Schaeffer's [director of research for the SIA] record keeping. In the boom year of 1999, brokerages underwrote \$2,238 billion (\$2.23 trillion) worth of corporate bonds and stocks – more than 22 *times* the dollar volume of underwriting that occurred in the whole of 1960s combined.

Another comparison: In 1974, the year before May Day, Wall Street raised only \$42 billion for American businesses. That's less than 2 percent of the 1999 level. In other words, for big brokerages, revenues from investment banking have grown roughly fiftyfold since 1974, while retail commission have drooped to the ankles.

The underwriting boom translates into industry profit, as brokerages collect underwriting fees of between 7 and 9 percent of the underwriting dollar volume. Too, brokerages obtain an allotment of stock and warrants in the underwritten company and can 'make a market' in the stock, earning trading commissions or even capital gains if they can sell their inventory at a profit (more easily done when the resident analyst keeps a 'buy' signal on)."⁸ (Brackets mine)

Brokerages also made a great deal of money in mergers and acquisitions. As such, this area of Wall Street has also seen stellar growth.

"There were 2,297 reported corporate merger deals nationwide, worth a cumulative \$11.8 billion, in 1975, the year of deregulation [of commissions] May Day, according to Mergerstat. By 1985, 3,001 domestic merger deals took place, worth \$179.8 billions. My 1995, there were 3, 510 deals, worth \$356 billion. In 1999, there were 9,278 deals, worth \$1, 428.1 billion (or nearly \$1.4 trillion)."⁹

Total M&A activity hit \$3.3 trillion in 2000. While there was slowdown over the 2000 to 2002 decline, 2005, the best year since 2000, came in at \$2.3 trillion. In the first six months of 2006, M&A activity has hit \$1,930 trillion. If this rate continues, 2006 will exceed 2000 and produce the highest level of M&A activity in history.¹⁰

So what happened to the few analysts that dared defy the institutional banking interests issuing negative reports? I could list dozens of examples from any number of books, but for the sake of time, we'll just look at one.

Howard Schilit(name his firm) is an independent analyst who is retained by about 250 institutional clients who pay well for his research. In 1997, he issued a report on HBO & Co, a designer of software for the healthcare industry. The industry was doing poorly, but HBO & Co was "growing," largely as a result of their acquisitions as a way to boost their performance numbers. Schilit's report noted that HBO's receivables were continuing to get older, meaning customers were taking longer to pay. Even though older receivables are less likely to be paid in full or paid at all, HBO was reducing its reserves set aside for bad debts, and was counting "unbilled receivables" (money HBO had yet to bill

customers for, but which it believed it was owed) as income, and was experiencing declining cash flow.

“Word of Schilit’s report leaked out on April 15, and HBO stock took a 25 percent haircut. The mainstream Wall Street analysts who followed HBO didn’t just ignore what Schilit had to say. To the contrary, they attacked him – viciously. No fewer than six analysts lambasted his report publicly, three of them actually issuing written rebuttals that impugned Schilit and his ethics. HBO officials derided him as a short. In fact, Schilit and troops abstain from speculating in stocks they cover.

In fact, Schilit’s report was not erroneous, nor did it contain any factual errors. It was only a careful review of financial numbers that HBO filed with the SEC.”¹¹

In January of 1999, HBO was bought by McKesson, becoming McKesson-HBO.

“In April of 1999, McKesson was forced to report that more than \$44 million in previously recorded revenues didn’t exist. The problem was – you guessed it – bogus revenues reported by HBO.

But after that, a lot started to look ill at McKesson-HBO. With more and more revenues of the former HBO beginning to look suspect, heads rolled, and four major accounting firms were brought in to try to clean up the mess. Talk was of restating profits going back two years, and earnings forecasts going forward were reduced. McKesson-HBO stock, which had peaked at \$90 a share in 1998, then traded around \$65 before irregularities were publicly announced, fell to \$33. McKesson- HBO never really recovered from the financial accounting fiasco, and into fall 2000 the company’s stock traded in the \$25-a-share range.”¹²

I can think of no better way to close this than with Cole’s own words.

“A question about the McKesson-HBO situation begs to be asked: ‘How come only Schilit called it?’ Schilit may be a smart forensic accountant, but he is only human. There are plenty of brokerage analysts loaded with business and accounting degrees just as impressive as his, plenty of other analysts with brains to burn. So why does it so often seem as if Schilit’s firm is the only one that can ferret out financial shenanigans? What about all those highly paid analysts at the major Wall Street brokerage houses?”¹³

While I’d like to believe that the industry and the regulators could do something to change this situation to benefit the investors, market history tells me it’s far more likely that the pain brought about by a bear market will produce the needed effect.

I’d like to thank Stan Brillo, mentioned in the chapter on short selling, for suggesting that I read this insightful and entertaining book.

To read some of our other postings, and learn about our [educational services](#), we encourage you to visit our [website](#). Our industry research paper on short selling, [Riders on the Storm: Short Selling in Contrary Winds](#), is available to those who subscribe to our monthly newsletter, *The Investors Mind: Anticipating Trends through the Lens of History*.

Sources:

1. [The Pied Pipers of Wall Street: How Analysts Sell You Down the River](#) (2001), Benjamin Mark Cole, page 97
2. *The Journal of Psychology and Financial Markets* (2002 Volume 3 Number 4), pages 198 – 201
3. Samex Capital's Stock Market Crosscurrents (September 26, 2005) Alan M. Newman, pages 1 & 2
4. [The Pied Pipers of Wall Street](#) (2001), Cole, page 61
5. Ibid, page 50
6. Ibid, page 57
7. Ibid, page 55
8. Ibid, pages 57 & 58
9. Ibid, pages 59 & 60
10. <http://www.oligopolywatch.com/stories/2005/09/05/mergersAndAcquisitions.html>
11. [The Pied Pipers of Wall Street](#) (2001), Cole, page 183
12. Ibid, page 185
13. Ibid