Independent Equity Research from Business Schools: A Possibility

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The investigations of New York Attorney General brought out the fact that research of investment banks had conflicts of interest. As a consequence, the need for independent research was recognized and a fund for independent research was set up there. The faculty and students of business schools have the capability to analyze the equity shares employing the analytical methods and disseminate research based recommendations to the investors. Such research can be disseminated through various means, institute website being one of them. This paper argues that business school faculty should take up the responsibility for preparing and communicating equity research reports and also describes two initiatives by business schools in this context.

Keywords: Equity Research, Independent, Business School, Analyst

1. Equity Research: Introduction

Equity research generally means preparing research reports with a recommendation to buy, sell or hold a security. The role of equity research is expressed in more general terms as providing information to participants in securities market regarding equity securities. Research provided by professional research outfits is valuable because each individual investor (institutional or individual) does not need to do complete analysis of all stocks. The division of labour between professional research outfits and investors makes the information processing more efficient.

According to Section 28(e)(3) of the Securities Exchange Act 1934 of USA, research is furnishing advice, either directly or through publications, as to the purchase value of securities, the advisability of investing in, purchasing, or selling securities. It also includes furnishing analyses, and reports concerning issuers, industries, securities, economic factors and trends, and portfolio strategy.

Equity research can be differentiated as Wall Street research and other research. Wall Street research is used here to represent research provided by the stock broking firms and is called "sell-side" research. Other research is done by investors themselves for their internal use and independent research firms that sell their research through various means to investors.

Wall Street research or the sell side research has become focused on large market capital companies' stocks and the majority of publicly-traded stocks are ignored by them. Other research fills the information gap created by sell side research.

The research provided by the stock brokers is distributed to the clients as an additional service but the broking commission charged by brokers providing research services is normally higher than the brokers who do not provide such services.

2. Conflicts in Sell-side Equity Research

Dugar and Nathan [3] outlined the conflicts faced by sell-side analysts in detail. Their study documented this phenomenon of incentives and conflicts of interest of analysts supported by anecdotal evidence and business press coverage only. They quote Dorfman [2] to identify the factors that determine the analyst's compensation. The factors identified are the volume of trading generated by the research reports of analysts, the evaluation of the analyst by the sales force of the broking firm, the success of buy/sell recommendations, their reputation as measured by their standing in the Institutional polls and their ability to secure and retain investment banking clients for their firm.

The conflict of interest encourages the sell side analysts to focus on 'buy' recommendations and delay 'sell' recommendations. When an analyst recommends 'buy', the firm's sales force can contact all his clients and urge them to buy the stock. In case of a sell recommendation, the sales force can contact only the existing holder of the stock. Also while investors in general are happy to go long on a stock, many of them are reluctant to go short on a stock, and this also limits the usefulness of sell recommendations. Sell side analysts who forecast decreases in growth rate of earnings or earnings itself and consequently a sell recommendation, may fall out of favour with the managements of the companies concerned and thus lose access to management of the company. As the company managements are a key source of valuable information, loss of access to company management may hamper future information collection by the analysts. Thus the need to generate brokerage commissions and to be on good terms with company management creates an incentive for stock-broking company analyst to be optimistic in their research reports for all the companies they cover.

The investment banking business also creates conflicts of interest for analysts of stock broking firms. Pressure is put on analysts by the investment banking department to be optimistic of the prospects of the firms that give investment banking business to them. Investment banking departments do so because of the apprehension that the client company will terminate its business with the broking firm if its analysts anticipate and communicate unfavourable developments about the company. The investment banking client can also put pressure on the broking firm and its analysts to report optimistic view. The analyst is thus aware that his broking firm's income is influenced by the nature of his research reports, and therefore has an incentive to issue optimistic reports about various companies.

The countervailing forces that can mitigate the undue optimism are the possibility that credibility of analysts and that of the broking firm will come down and the possibility of lawsuits from aggrieved customers. Dugar and Nathan [3] argued that the countervailing forces might only limit the magnitude of relative optimism.

The conflicts of interest of analysts of sell-side firms were investigated by New York state attorney general Eliot Spitzer and a global resolution emerged out of this investigation [7]. One of the conclusions of the investigation was that many stock

broking firms routinely disseminated tainted investment advice or research that was designed to help investment banking clients but harmed other investors. A systemic reform was attempted in the global settlement reached by securities regulators and leading investment banking firms of USA. The reforms include;

- A clear separation of the research and investment banking divisions at firms – analysts will no longer be allowed to accompany investment bankers on pitches and road shows or solicit investment banking business.
- A new mechanism for providing independent research to investors at no cost to help them make more informed decisions – independent research will guarantee that the retail customers have alternative views, and the analyst will know that he or she is being judged by comparative independent analysis.
- Transparency of rating information – Each firm will publish its rating of securities on its website within 90 days after conclusion of each quarter. This information can be used by investors to compare and evaluate the relative performance of different analysts.
- Investor education – programs will be established to help investors protect themselves against securities fraud.

The global resolution and settlement that is a part of it, gave an impetus to independent research, research carried out by entities other than stock broking firms.

3. Independent Equity Research

The equity research carried out by entities other than stock broking firms is termed as 'independent equity research.' Equity research carried out by a prominent entity like Standard and Poor's is independent equity research. News papers, business magazines, and specially published investment magazines also provide independent equity research service. There are many investment advisors who publish news letters. Independent research firms are providing research on the stocks that have been orphaned by Wall Street. This means that independent research firms are becoming the main source of information on the majority of stocks. Investors have to pay separately for research when they buy from independent research firms, or when they buy dailies or magazines. In general, individual investors do not buy research reports from independent research outfits as the price tag on these reports is often quite high. Individual investors do buy investment magazines and hence we can say that individual investors are willing to pay something for independent research. Institutional investors employ analysts and do research and also buy research from independent research organizations.

If individual investors are unwilling to buy research from independent research firms at appropriate price, how will the market correct the imbalance caused by the lack of coverage? Fee based research is presented as one alternative. In fee based research, a company pays a fee to a research firm to prepare its research report on it and distribute it to the investors. Fee-based research increases market efficiency and bridges the gap between investors who want research (without paying) and companies who realize that Wall Street (stock-broking firm) is not likely to provide research on their stock. Fee-based research provides information to the widest

possible audience at no cost or charge to the reader because the subject company has funded the research.

Companies who engage a legitimate fee-based research firm to analyze their stock are trying to get information to investors and improve the marketability of their company's shares.

Companies employ fee-based research strategy when they believe that their shares are undervalued and its investment potential can withstand objective analysis. The fee based research is gaining market acceptance. The National Investors Relations Institute (USA) endorsed it by encouraging small-cap companies to find alternative to stock-broker research.

4. A Role for Business Schools in Practical Equity Research

Security Analysis is a subject in the curricula of many business schools. For students majoring in Finance specialization, this is an important subject. Equity research or analysis is an important component of this subject. In several business schools, experiential learning is emphasized, and students are assigned the task of analyzing the actual companies in real time to learn and apply the principles and techniques of security analysis. Thus both the students and faculty of Security Analysis are actually carrying out analysis of various equity securities on a continuous basis. But a search of web documents, reveals that reports produced by students under the supervision of faculty or reports produced by faculty are not available. In contrast, reports produced by stock broking firms or even independent research firms are available in large numbers. So business school faculty members are not taking interest in disseminating the equity research that they carry out and the research that they are facilitating. In this context attention is drawn to the paper by Kalra and Weber [4] where they described a comprehensive stock analysis project that students of Investment course carry out as an assignment.

The basic advocacy of this paper is that there is an opportunity for business school faculty and business schools to disseminate equity research to investors. Whether it will fetch revenues or not can be decided by actual trials by some schools. But business schools having their web sites can disseminate the research by posting the reports on the site. Such a provision of equity research reports through net by business schools can provide an opportunity to public to access reports that emphasize adherence to principles and techniques of security analysis. Public will be in a position to compare reports of business school faculty with that of professional analysts and mitigate the biases. Practical application of the research conclusions can be attempted by business school faculty, research scholars and students through practice-relevant equity research reports. The initiative of providing equity research done by students to public investors and professionals is described briefly in the following section. It would support the argument that investors may be willing to listen to the advice of business school faculty and business school students supervised by the faculty.

5. Khoj: Equity Research Competition for Business School Students

Recognizing the lack of equity research reports, an all-India equity research contest for business school students was organized. The contest with the brand name 'Khoj'

(khoj means discovery) was organized for the first time in December 2002 by the S.P. Jain Institute of Management and Research, Mumbai. It was well received by the business school students and they mentioned in their feedback that they were awaiting such a contest. Entries for the contest came from all leading business schools of India including all IIMs. Seven professionals from broking firms heading equity research and fund management, mutual funds and business periodicals acted as judges of the event. The audience was mainly solicited from business schools and over 150 participants attended the event. The judges appreciated the efforts of the students in preparing the research reports. But one problem that was identified in this competition was that it was difficult to verify or confirm that the report was an original work and was not a copy of some analyst's report. While for the purposes of competition, the students can be evaluated on their presentation, for using the reports for public dissemination, precautions against plagiarism have to be taken. This equity research competition was further held in 2003, 2004 and 2005.

6. Investor Meet by Business School Students

In the year 2005, an innovative pedagogy was suggested for Security analysis. Each student was assigned two companies to analyze. Each week, some steps of the analytical procedure were specified to be completed on each of the two companies. Students liked the idea and involved themselves actively in this real-life real time project. Students were asked to analyze securities using five analytical methods, namely: Graham-Rao method [6], Dividend discount model [8], Target price method [1], Piotroski method [6] and Technical analysis [5]. The report on each company has analysis carried under these five methods. Graham-Rao method and Dividend discount model are methods for buy-and-hold investors. Target price method, Piotroski method and Technical analysis method are methods for active investors or traders. An investor meet was organized to disseminate the results of this security analysis exercise carried out by students. The investor meet was announced as an event wherein students will present the results of their extensive research on 150 stocks. Students presented five stocks under each method as candidates for buy. There was a good response to this public event organized to educate and empower the investors. Over 150 investors and aspiring investors and analysts attended this meet and they appreciated the efforts of the students. An investment analysis workshop to explain the methodology of each method was announced in the investor meet. A large number of participants in the investor meet attended the workshop.

It was decided by the students who organized the investor meet that this would be an annual feature. The success of the event provides the evidence that equity research carried out in business schools has relevance for practice.

The challenge for the business school and faculty is to improve the accuracy of the research reports and then only these reports can be uploaded to the institute web site. The faculty is to be supported by data-base assistants and teaching/research assistants who can help the students in properly accessing the data bases as well as verify the analyses and reports prepared by the students. Validation of the results of research has to be done by continuous monitoring to strengthen the credibility and usefulness. Students also have to be motivated to take up greater responsibility as their reports may go to the public. There can be certainly revenue opportunities in this exercise, but this is not an explored in this paper as it is not the immediate focus of this paper.

7. Conclusion

Independent equity research is research carried out by entities other than stock broking firms. Independent research is a countervailing tool to the conflicts of interest present in the sell-side research. The global resolution of 2003 provided an impetus to independent equity research. The research carried out by business school students and facilitated by faculty has value which can be passed on to investors by dissemination of research results to investors through various media especially through the institute web site. The overwhelming response received from all concerned to the two events described above lends support to the proposition that research undertaken by business schools would serve the investors gainfully.

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