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Analysts' Choices Had Another Bad Year, but Why?

By MARK HULBERT

A new study of brokerage analysts' ratings offers more ammunition for Wall Street's critics. In 2001, for the second consecutive year, the stocks that analysts rated highest did far worse than those rated lowest.

The report is a follow-up to studies of analysts' performance since 1986. From that year through 1999, the stocks recommended most highly by Wall Street analysts outperformed the stocks they rated the lowest. This pattern reversed in 2000 and 2001, the new study shows. The study's authors were Brad M. Barber, a finance professor at the University of California at Davis, and three accounting professors: Reuven Lehavy of the University of Michigan, Maureen F. McNichols of Stanford and Brett Trueman of the University of California at Berkeley.

The professors constructed a consensus rating for each stock, using a database from Thomson First Call for ratings issued after 1996 and one from Zacks Investment Research for the decade before that. The researchers used these ratings to create five portfolios. Portfolio 1 contained the approximately 20 percent of stocks with the highest average ratings, while Portfolio 5 had those at the bottom. The portfolios shifted whenever stocks' consensus ratings changed.

Two years ago, the professors found that in every year from 1986 to 1999, Portfolio 1 outperformed Portfolio 5 by a significant margin. Over those 14 years, Portfolio 1 gained 20.5 percent, annualized, while Portfolio 5 gained 3.3 percent. (The overall market, measured by the Wilshire 5000, gained an annualized 17.1 percent over that time, but because the professors did not include transaction costs, it is unlikely that investors mimicking Portfolio 1 would have beaten this benchmark. Still, the professors found it noteworthy that analysts' highest-ranked stocks performed so much better than their lowest-ranked issues.)

The professors have now found that the performance of the analysts' recommended stocks plummeted in 2000 and 2001. Over those two years, Portfolio 1 produced an annualized loss of 18.1 percent, versus a 2.3 percent gain for Portfolio 5 — a spread of more than 20 points. The Wilshire lost 10.9 percent, annualized, over that time.

According to the professors, these results reflect the poor performance of the type of stocks that analysts tend to rate highest. During the 16 years studied, stocks with the highest ratings came predominantly from the small-cap growth sector. By contrast, the stocks with the lowest ratings came largely from the small-cap value category.

The professors did not speculate why analysts have these preferences, but I suspect that they can be traced in large part to brokerage firms' investment banking activities. Other research has shown that, after firms go public, they are almost always small-cap growth companies. To attract them as clients, analysts may become cheerleaders for the sector.
The performance of small-cap growth stocks took a sharp turn for the worse in early 2000, especially in comparison with small-cap value stocks. As measured by the Russell 2000 Growth and Russell 2000 Value indexes, the spread in favor of small-cap value was more than 34 percentage points a year for 2000 and 2001.

Given that huge spread, the professors considered it noteworthy that the analysts' highest-rated stocks lagged behind their lowest-rated ones by just 20 percentage points a year in 2000 and 2001. In fact, they found that over the entire 16 years, the stocks with the highest consensus ratings consistently outperformed the small-cap growth sector as a whole.

The analysts appeared to have no insight into when small-cap growth stocks would outperform small-cap value stocks. But they did manage to pick small growth stocks that beat the sector average. If there is a lesson here, it could be this: Pay attention to the Wall Street consensus if and when you have already decided to invest in the small-cap growth sector.