Wall Street's Finest

The S&P 500 index gained a total of 16.0% in 2012. Not a bad performance overall, but the returns for each of the 500 individual stocks within the index cut a fairly wide swath. The best-performing stock, Pulte Homes (NYSE: PHM), nearly tripled in value; and the worst-performing stock, Apollo Group (NASDAQ: APOL), declined by more than 60%.

Which caused us to wonder …. what were the Wall Street analysts saying about those two companies back at the beginning of the year? Did they have any inkling of the dramatic performances which were about to take place?

For Pulte, we checked the analyst ratings listed on Yahoo! Finance and saw that there were 11 Wall Street brokerage firms which had published their opinions on PHM since the great stock market swoon in late 2008. Of those 11, five rated the stock as a "buy," five rated the stock as a "hold," and one rated it as "sell" at the beginning of 2012. So five out of the eleven liked it—not bad. But still, more than half the analysts did not rate it as a "buy."

Of course, by the end of February, two of the five "buy"s had been changed to "hold"s after PHM ran up about 40% in the first two months of the year, causing investors who listened to those two analysts to miss out on the subsequent double over the remainder of the year.

Either way you look at it, though, the majority of Wall Street analysts did not recommend buying PHM before its stunning performance in 2012.

No Called Strikes in Investing

That's not so bad, though. According to Warren Buffett's famous baseball analogy, there are no "called strikes" in investing. That is, an investor shouldn't feel too bad about missing out on a hot stock. The important thing is to not lose money, because climbing out of an investment hole is always much harder than falling in one in the first place. In numerical terms, it takes a 67% gain to recover from a 40% loss, for instance.

So how did the Wall Street analysts do on the job of protecting their investors from Apollo's precipitous fall? According to a recent analysis reported by Brett Arends of the Wall Street Journal, there were 20 analysts covering Apollo at the beginning of 2012. Eight of them rated APOL as a "hold," and the other twelve all said "buy."

D'oh.

No Cherry-Picking, Either

But all of this is a bit unfair, isn't it? Just taking the one worst-performing stock of 2012 and showing that the majority of Wall Street analysts actually recommended buying it, and then taking the best-performing stock of 2012 and showing that the majority of Wall Street analysts did *not* recommend buying it?

Surely these highly-paid analysts have a much better track record when you look at their overall record, as opposed to just one or two stocks that have been cherry-picked from among all the others? Right?

Well, no.

Through the Looking Glass

Mr. Arends also analyzed what would happen if you looked at the last five years of Wall Street analyst picks. Specifically, he took the ten most popular stocks and ten least popular stocks for each year from 2008 through 2012 across all sell-side analysts. He constructed a hypothetical portfolio for the most popular stocks, another for the least popular, and then compared their performance to each other and to the overall S&P 500 index.

The benchmark index rose a total of 9% over that five-year period, or a little less than 2% per year on average. The portfolio of the most-loved stocks by the analysts actually *declined* by 11%, and the portfolio of the most-hated stocks increased by 16%.

It would seem that the world of Wall Street analysts is a topsy-turvy one, where investors would do best to do exactly the opposite of whatever the analysts say they should do.

Safety in the Herd

This should not be an overly surprising result, though. Wall Street analysts are highly compensated individuals. Their one over-arching motivation in life is probably to hold on as tightly as possible to their job.

If most analysts rate a certain stock as a "buy," but one analyst thinks that it's probably actually a "sell," that dissenting analyst has powerful incentives leading him to go along with the "buy" consensus, against his own personal judgment. The reason for that is that if he gives the stock a "sell" rating and it declines like he thinks it will, then he will be filled with a warm, fuzzy feeling of being correct. But not much else. His bonus won't be any higher, and he won't be eligible for any big promotion. He's already pretty much at the top.

However, if he rates the stock a "sell," and then it goes up substantially, his foolishness will be all the more visible by the fact that he was alone in his wrong-thinking, possibly even to the point of putting his job in jeopardy.

It's like flipping a coin where heads wins you a dollar, and tails costs you your life.

A Bite of the Apple

We have seen exactly this sort of behavior recently in one of the most popular stocks of the day: Apple (NASDAQ: AAPL).

Early last year as Apple's stock climbed steadily upward, at one point cresting over the barrier of $700 per share, Wall Street's analyst community was falling all over itself trying to recommend the stock to investors.

You may know what has happened since. From that high point near $700, AAPL started to decline, first to around $525 then, after a brief reprieve, again to around $450 today. That's a decline of 36% during a period when the S&P 500 has actually gained a few percent.

Throughout that decline, 50 of the 57 analysts who follow AAPL rated the stock as either "buy" or "strong buy," according to a recent New York Times article. One former sell-side analyst was quoted in that article as summing up the situation thusly: "Wall Street is … incompetent at picking stocks." One of us happens to have spent a few years working in the bowels of the Wall Street machine, and we could not agree more.

It's All In the Name

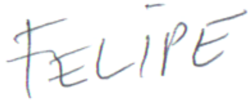
Sarbanes-Oxley, enacted after the widespread anger over analyst wrongdoings with companies such as Enron and WorldCom, and the global settlement with the state of New York were supposed to correct problems like these. The theory was that Wall Street analysts were too bullish on stocks in general, because their point of view was compromised by the fact that their employers were often seeking investment banking business from the same companies that the analysts were supposed to be "independently" researching.

The global settlement and Sarbanes-Oxley ostensibly removed those conflicts, and yet over a decade later here we are amidst a perennially bullish sell-side analyst community. And the simple reason for that is in the industry's very name: sell-side.

These analysts, who we facetiously dub Wall Street's Finest, work for brokers, and brokers earn their money via trading commissions. The easiest way to generate a trade commission is to call a client, tell them about the latest hot stock tip, and offer to place the trade order on their behalf. You'll never hear of a broker making a "hold" call to a client, and "sell" calls only work if the client happens to already own the stock in question. Hence, the bullish bias persists.

Conclusion

If there is any lesson to draw from all this, it's that an investor should pay almost no attention whatsoever to the opinions of "Wall Street's Finest." In fact, if any attention is paid at all, it might be more beneficial to do the exact opposite.



Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC