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How firms fool equity analysts

Stockpickers suckered

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Chief executives pull the wool over analysts' eyes, again

Illustration by Claudio Munoz

HOW do you pump up the value of your company in these difficult times? One tried and tested way is to hoodwink equity analysts, according to a new study* of 1,300 corporate bosses, board directors and analysts.

The authors found that chief executives commonly respond to negative appraisals from Wall Street by managing appearances, rather than making changes that actually improve corporate governance: boards are made more formally independent, but without actually increasing their ability to control management. This is typically done by hiring directors who, although they may have no business ties to the company, are socially close to its top brass. According to James Westphal, one of the study's co-authors, some 45% of the members of nominating committees on the boards of large American firms have "friendship" ties to the boss—though this varies widely from company to company.

The tactic pays off with appreciably higher ratings. At firms that make a strenuous effort to persuade analysts that such board changes have boosted independence, and thus made management more accountable, the likelihood of a subsequent stock upgrade rises by 36%, the study concluded. The chance of a downgrade, meanwhile, falls by 45%.

Why do analysts swallow this self-interested narrative? Respondents acknowledged that social ties could undermine independence, but most said they do not have the time to look into such issues. It would help if companies disclosed such relationships in their standard company literature, suggests Mr Westphal. He thinks they should also list shared appointments—when the boss and a director sit together on another firm's board.

Depressingly, these market-distorting shenanigans are part of a pattern. An earlier study found that public companies commonly enjoy lasting share-price gains from plans that please analysts, such as share buybacks and long-term incentive schemes for executives, even when they fail to follow through on announcements. Another concluded that the further a firm's profits fall below consensus forecasts, the more favours its managers bestow on analysts—such as recommending them for jobs and even securing club memberships for them—and the lower the likelihood of a further downgrade. If investors rated analysts, those taken in by such blatant attempts at manipulation would surely earn a "sell".

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* "A Matter of Appearances: How Corporate Leaders Manage the Impressions of Financial Analysts about the Conduct of their Boards", by James Westphal and Melissa Graebner, Academy of Management Journal, February 2010