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Buys, holds, and sells: The distribution of investment banks' stock ratings and the implications for the profitability of analysts' recommendations ☆

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Abstract

This paper analyzes the distribution of stock ratings at investment banks and brokerage firms and examines whether these distributions can predict the profitability of analysts' recommendations. We document that the percentage of buys decreased steadily starting in mid-2000, likely due, at least partly, to the implementation of NASD Rule 2711, requiring the public dissemination of ratings distributions. Additionally, we find that a broker's ratings distribution can predict recommendation profitability. Upgrades to buy (downgrades to hold or sell) issued by brokers with the smallest percentage of buy recommendations significantly outperformed (underperformed) those of brokers with the greatest percentage of buys.

JEL classification: G12; G14; G24; G29

Keywords: Analyst; Recommendation; NASD 2711; Investment bank; Stock rating; Broker

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0. Introduction

This paper analyzes the distribution of stock ratings at investment banks and brokerage firms and examines whether these distributions can be used to predict the profitability of analysts' stock recommendations. Our study comes at a time of increased scrutiny by Congress and securities regulators of potential analyst conflicts of interest. With the percentage of buy recommendations reaching 74 percent of total outstanding recommendations by mid-2000 and the percentage of sell recommendations falling to 2 percent, allegations arose that analysts' recommendations did not reflect their true beliefs. Rather, it was contended that, among other things, the recommendations were intended to attract and retain investment banking business. The steep stock market decline during 2000–2002, whose beginning coincided with peak bullishness on Wall Street, only served to fuel the concerns of regulators and politicians.

As part of its attempt to more closely regulate the provision of research on Wall Street, the National Association of Securities Dealers (NASD) proposed Rule 2711, *Research Analysts and Research Reports*, in early 2002. Around the same time, and with the same goal in mind, the New York Stock Exchange (NYSE) proposed a modification to its Rule 472, *Communications with the Public*. The Securities and Exchange Commission (SEC) approved these proposals on May 8, 2002. Among their provisions, these rules require all analyst research reports to display the percentage of the issuing firm's recommendations that are buys, holds, and sells.[1]

This disclosure requirement was intended to provide investors with information useful in evaluating the quality of brokerage firms' recommendations. Announcing the approval of NASD 2711, the SEC stated in its press release of May 8, 2002, that "These disclosures [regarding brokerage firms' ratings] will assist investors in deciding what value to place on a securities firm's ratings and provide them with better information to assess its research." This objective was echoed in a speech by Mary Schapiro, President, NASD Regulation, to the 2002 SIA Research and Regulation Conference on April 9, 2002, where she remarked that "While there may be good reasons why a firm has assigned a buy or strong buy to 80 percent of the companies it covers, investors have a right to know this information. It suggests a bias in the firm's coverage that investors should take into account in evaluating ratings… Our proposal [NASD 2711] would require firms to disclose this information." In addition to providing investors with useful information, the new disclosure requirement was presumably also meant to implicitly pressure those brokers (and their analysts) who were consistently issuing a relatively high percentage of buy recommendations to adopt a more balanced ratings distribution.

The regulatory and political focus on brokers' stock ratings distributions and the subsequent requirement that these distributions be disclosed invite a number of interesting questions. First, did the 10 large investment banks sanctioned for alleged analyst conflicts of interest by the SEC in the 2003 *Global Research Analyst Settlement* issue the most favorable recommendations? Second, does a greater proclivity towards issuing buy recommendations imply that a brokerage firm's recommendations have less investment value? Alternatively stated, would knowledge of a broker's ratings distribution be useful in

[1]For ease of exposition, the discussion in the remainder of the paper is framed solely in terms of NASD Rule 2711. However, because the modified NYSE Rule 472 has an identical reporting requirement, all conclusions clearly apply to it as well.