Available online at www.sciencedirect.com
ScienceDirect
Journal of Financial Economics 85 (2007) 490–517
JOURNAL OF Financial ECONOMICS
www.elsevier.com/locate/jfec

# Comparing the stock recommendation performance of investment banks and independent research firms ☆

Brad M. Barber[a], Reuven Lehavy[b], Brett Trueman[c,*]

[a]*Graduate School of Management, University of California, Davis, CA 95616, USA*
[b]*Ross School of Business, University of Michigan, Ann Arbor, MI 48109, USA*
[c]*Anderson School of Management, University of California, Los Angeles, CA 90095, USA*

Received 27 September 2004; received in revised form 12 July 2005; accepted 19 September 2005
Available online 29 March 2006

**Abstract**

From January 1996 through June 2003, the average daily abnormal return to independent research firm buy recommendations exceeds that of investment bank buy recommendations by 3.1 basis points (almost 8 percentage points annualized). Investment bank buy recommendation underperformance is more pronounced following the NASDAQ market peak (March 10, 2000) and strikingly so for buy recommendations on firms that recently conducted equity offerings. In contrast, investment bank hold and sell recommendations outperform those of independent research firms by 1.8 basis points daily ($4\frac{1}{2}$ percentage points annualized). These results suggest reluctance by investment banks to downgrade stocks whose prospects dimmed during the bear market of the early 2000s, as claimed in the SEC's *Global Research Analyst Settlement*.


*JEL classification:* G12; G14; G24; G29

*Keywords:* Analyst; Recommendation; Investment bank; Independent research; Global Research Analyst Settlement

☆We would like to thank Mark Chen, Maureen McNichols, Rene Stulz, Beverly Walther, two anonymous referees, and participants at Carnegie Mellon, Columbia University, IESE Business School, MIT, Northwestern University, the Universities of Chicago, North Carolina, and Waterloo, and the Federal Reserve Bank of New York/*Journal of Financial Economics* Conference for their many valuable comments. We also thank Thomson Financial for providing access to the *First Call* database. All remaining errors are our own.

*Corresponding author. Tel.: +1 310 825 4720.
*E-mail address:* brett.trueman@anderson.ucla.edu (B. Trueman).

0304-405X/$ - see front matter 
doi:10.1016/j.jfineco.2005.09.004

## 1. Introduction

On April 28, 2003, the Securities and Exchange Commission (SEC) announced a historic agreement with ten of the largest investment banks.[1] This agreement, known as the *Global Research Analyst Settlement*, was the culmination of extensive investigations by Congress, New York Attorney General Elliot Spitzer, the SEC, and other regulators into potential conflicts of interest among security analysts employed by investment banking firms. Alleging numerous incidents of analysts compromising the integrity of their research in order to generate investment banking business, the agreement requires the ten firms to pay $875 million in penalties and disgorgement of profits, $80 million for investor education, and $432.5 million to fund independent research. In addition to these payments, the investment banks must separate their investment banking and research departments and add a number of specific disclosures to their research reports. They must also provide independent securities research to their retail clients, in order to "…ensure that individual investors get access to objective investment advice…".[2]

Motivated by this last requirement, and the arguably implicit assumption that the recommendations of independent research firms are superior to those issued by investment banks, this study compares the overall performance of the stock recommendations of the two types of firms. We also test the implicit (if not explicit) allegation by the SEC in its individual complaints against the investment banks that analyst conflicts of interest resulted in a reluctance to downgrade buy-rated stocks during the bear market of the early 2000s. If banking analysts were issuing buy recommendations during this period when holds or sells were deserved, then we should observe their buy recommendations underperforming those of independent research firms over this time. Moreover, with potential analyst conflicts of interest arguably strongest for covered firms with recent investment banking activity, underperformance should be greatest for the buy recommendations issued on those firms. Conversely, with banking analysts reluctant to issue holds and sells during the bear market, such recommendations, when issued, are likely to reflect quite unfavorable news; consequently, they should earn more negative returns than those of analysts at independent research firms, who presumably do not have a similar reluctance to issue hold and sell recommendations. Since the SEC's allegation focuses on the bear market, we make no relative performance predictions for the bull market.

Our analysis utilizes the *First Call* database, which contains almost 335,000 recommendations issued on more than 11,000 companies by 409 securities firms. We partition these recommendations into those issued by investment banks and those provided by independent research firms (defined here as either pure research firms or firms with research and brokerage activities, but without investment banking business). Each of these two samples is further subdivided into buy recommendations (including upgrades to buy or strong buy, and initiations, resumptions, or reiterations with a buy or strong buy

[1]The ten firms are Bear Stearns, Citigroup (formerly Salomon Smith Barney), Credit Suisse First Boston, Goldman Sachs, J.P. Morgan Securities, Lehman Brothers, Merrill Lynch, Morgan Stanley, UBS Warburg, and U.S. Bancorp Piper Jaffray.

[2]Joint Press Release of the SEC, New York Attorney General, North American Securities Administrators Association, National Association of Securities Dealers, and the New York Stock Exchange, April 28, 2003, p. 4. The press release specifies that "For a five-year period, each of the firms will be required to contract with no fewer than three independent research firms that will make available independent research to the firm's customers."