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VALUE DRIVEN

Wall Street's Trust Fund Is Tapped Out
Just when we thought Wall Street banks had
come clean ... surprise!

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By Geoffrey Colvin



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For just a moment, it was almost possible to believe again in stock research from the major Wall Street firms. But now? How deep a hole do those guys have to be in before they stop digging?

We thought we had identified the problem: The so-called analysts at the big firms turned out to be utterly beholden to the investment-banking side of the business, which makes all the profits. So the analysis wasn't analysis, it was just marketing for I-banking clients, masquerading as objective research. The banks admitted it without formally admitting it, fired some high-level executives, adopted new policies, and made a show of cleaning house. Problem addressed, if not solved.

How naive we were. In the just-announced global settlement, the enforcement bodies alleged that some big banks had been paying one another to issue positive "research" about clients. The banks didn't admit or deny the allegations, though news accounts quoted industry insiders acknowledging the practice.

To weary investors it sounds like just another shot of sleaze, but it's much more. The enforcers' main charges about investment-banking conflicts, and the many incriminating e-mails supporting those charges, were out there for months before the formal settlement. Politicians know what to do in this situation: If a reporter discovers you had an extramarital affair while campaigning for family values, you put out a press release expressing sorrow and contrition while also mentioning that you dealt crystal meth in college and haven't filed tax returns for five years. Get it all out and try to move on.

But the I-banks didn't do that. While assuring us of their deep belief in integrity, they were keeping a slimy secret in the basement, which suggests they thought they could keep it there.

The firms were willing to mislead the media over the matter, not something a major company does lightly. When it became obvious over a year ago that big banks' analysts were fundamentally compromised by

investment banking, the financial media--TV, magazines, newspapers--began routinely asking analysts whether any company they were recommending was an investment-banking client of the firm. But our minds were not sufficiently twisted. When the analyst answered with a cheerful no, it never occurred to us to ask, "And has your firm been paid for this opinion by a competing firm for which this company is a client?"

We thought we were protecting our readers and viewers. In truth, the firms were prepared to deceive us even more deviously than before. Until the announcement of the settlement, they apparently had no intention of telling anyone.

So now we're supposed to trust them? In view of the record, how much money would you bet that they're now clean as a whistle? How much do you trust the vaunted Chinese walls between stock research and investment banking? Remember, they were supposedly always there. As part of the settlement, the firms have promised not to pay analysts on the basis of I-banking results. So what? Investment banking is still where firms make their money. For an analyst, trashing the firm's clients--even if they deserve it--is not the path to career glory and never will be, no matter how compensation is structured.

And trusting companies is getting to be as tough as trusting brokerages. After Tyco's spectacular deceptions, its new management announced a microscopic inspection of the books and declared all problems found. Then it went to the public markets for a major debt refinancing. Then--oops!--it announced newly found accounting errors requiring a \$1.1 billion charge to earnings.

Seems to me investors have three choices. You can adopt the Warren Buffett principle and invest only in companies whose management you personally know and trust. That would limit most investors' options pretty severely. Or you can use research from an unconflicted source, with the hurdle for unconflictedness set extremely high. Or you can buy the entire market in the form of a Wilshire 5000 index fund and stop worrying about trusting anyone or anything except the growth of the U.S. economy. That's what Nobel Prize-winning finance wonks have been advising for decades. It's sounding better all the time.

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