

Preface

Wall Street or sell-side equity analysts provide research products and services on publicly traded companies to institutional and retail investors (collectively referred to as the “buy side”) to help them make more profitable investment decisions. In supplying this research, sell-side analysts also provide a service to the companies they analyze by helping to create a liquid market for their stocks. As a result of their role as financial intermediaries that serve two distinct constituencies, each with its own agenda, sell-side analysts face inherent conflicts of interest.

During the last ten years the sell-side industry has been battered by a series of shocks. As concerns over conflicts of interest mounted, the integrity of its research output was questioned, leading to transformative regulatory changes. New technologies emerged to democratize information and change the way stocks are traded, threatening the industry’s product and business model. There were upheavals and stagnation in established core financial markets such as the United States, Japan, and Western Europe. And burgeoning new markets in countries such as China and India raised potential challenges to the dominance of leading firms.

Despite our common interest in the sell-side equity industry and in these changes, our areas of expertise are quite different. Boris’s prior research examines how financial intermediaries acquire, develop, and reward star sell-side analysts, whereas Paul’s focuses on the tools that enable sell-side analysts to develop insights into firms’ competitive positioning and to assess their values. Yet our fascination with the changes we have lived through during the last ten years brought us together to write this book.

Actually, we didn’t start out to write a book. Instead, over time we undertook a series of case studies, field interviews, and academic studies that we hoped would provide us with insights into the effects of the above

changes and the industry's future.¹ But as we reflected on the portfolio of research we had completed, we recognized that it told a fascinating story of an industry that has proven to be remarkably resilient in resolving economic and regulatory challenges. Our goal is to provide practitioners and academics with a deeper understanding of the forces that have shaped the industry and the factors that account for its resilience.

The book consists of eight chapters. Chapter 1, "The Rise and Fall of Equity Research at Prudential," profiles how the Prudential Insurance Company built and dismantled a research department over almost three decades. The Prudential story highlights many of the key trends that have affected sell-side research over time, focusing on, among other things, the financial pressures faced by sell-side research departments due to the delinking of investment banking and research and the move to low-cost trading platforms resulting in lower per share commissions.

In Chapter 2, "What Do Analysts Do, and How Are They Managed?," we look closely at the job of an equity research analyst: what they do, how they are hired, how they are evaluated, and how they are compensated. Chapter 3, "Sell-Side Research: The History of an Information Good," reviews the economic challenges that sell-side firms experience in monetizing their research output and discusses the two models that have been developed to mitigate problems of information goods and generate revenues for sell-side research, the trading commission model and the investment banking model.

In Chapter 4, "Investment Banking Model Challenges," we examine the rise of the investment banking model in the 1990s and the impact that it had on the sell-side industry. We evaluate the impact of the Global Settlement of 2003 on the use of investment banking to fund research.

Chapter 5, "Challenges to Trading Commission Model," explores the recent evolution of the trading commission model and the challenges that this model has faced due to the enactment of Regulation Fair Disclosure (Reg FD) in 2000 and to technological advancements that have had an impact on stock trading as well as information gathering and dissemination.

Chapter 6, "The Performance of Sell-Side Research Analysts Revisited," presents our findings on sell-side analysts' performance by comparing quantitative measures of analyst performance for different types of sell-side analysts, such as those at investment banks and those at brokerage firms. We then examine how sell-side analysts' performance compares to that of their buy-side counterparts.

Chapter 7, “The Future of Sell-Side Research in the United States,” examines a variety of innovations by sell-side research firms in the United States in response to the regulatory and technology challenges discussed in Chapters 4 and 5. Many of these innovations seek to segment the research market and provide firms with opportunities to provide more valued services to their leading clients.

Chapter 8, “Sell-Side Research in Emerging Markets,” looks at the development of the sell-side research industry in China and India. We discuss the factors that have enabled sell-side research in these countries to enjoy rapid growth and more attractive pricing than in the United States.

Finally, in Chapter 9, we draw conclusions about the industry, its challenges, and its future.