Investor beware – financial markets are laden with conflicts of interest

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SPECIAL TO THE GLOBE AND MAIL
PUBLISHED YESTERDAY
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Financial markets are laden with conflicts of interest. Professional portfolio managers have them, as do analysts, rating agencies and some financial media. Investors must understand this. No one is watching investors' backs; it is their job to do so.

Case in point is Generac Holdings Inc. , whose stock is down 77 per cent since the peak of US$524 on Nov. 2, 2021. Buying the dips has not worked. And yet, roughly half of the 24 analysts who cover the stock have had buy ratings since the Nov. 2 peak, according to Refinitiv Eikon data. Up until this month, not one had a sell rating. What will it take for analysts to have a sell rating for the stock? And why do they avoid them?

Let's look at how conflicts induce recognizable patterns of behaviour among all elements of the financial markets, not just analysts.

Institutional investors

What are the conflicts of interest among professional portfolio managers and what effects do they have on stock prices?

a) Herding

Professional portfolio managers herd to protect their jobs and assets under management rather than maximize their client's returns. Herding is a conflict-induced behaviour and a key aspect of why prices and value diverge on a regular basis.

b) Portfolio rebalancing and 'window-dressing'

Portfolio managers have an annual remuneration cycle. They invest in January; if by December they beat their benchmarks, they get a bonus. And their Christmas bonus is big. In the new year, they ask themselves, what should we do to outperform our benchmark? They have learned at university that higher risk leads to higher return. As a result, every January they let their portfolio take on securities that are riskier than their benchmark. (This is done individually yet also collectively as a herd.) Subsequently, for the rest of the year, they slowly get out of those riskier securities and go back to benchmark securities or even safer securities such as government bonds. This way they are locking in their Christmas bonus.

Furthermore, they “window-dress,” that is, toward the end of the year, they sell their losing stocks, their obscure stocks, and load up on winning and glamorous stocks. Why? Because they want to spruce up the portfolio so that when they send their clients their annual report, it shows they only own good-quality stocks.

What pattern does this behaviour induce on stock prices throughout the year? This pattern is the well known “January effect” and is related to the “Sell in May and go away” effect. Riskier stocks are bid up in January as the herd gravitates toward them. Throughout the year, as portfolio managers get out of riskier securities, riskier stock prices decline, with the worst months of the year being September and October. In other words, the conflict-of-interest-driven trading behaviour by portfolio managers makes stock prices, even within the year, diverge from fundamental value.

Analysts

Analysts have conflicts of interest – that is why their stock recommendations are predominantly buys over sells by a seven to one ratio. There is plenty of academic evidence to indicate that analysts tend to be over-optimistic about a company’s earnings forecast, and the more the uncertainty surrounding a company’s future, the more over-optimistic they are. Analysts want to generate trading profits for their firms. They are, after all, in the business of selling stocks. Moreover, they are motivated to write positive stories about companies. Why? The chief executive officers of companies for which they write unfavourable stories may get upset at the analysts (or blacklist them) and no longer give them access to company information. Or they may not give business to the corporate finance side of the analysts’ investment banking arm.

Rating agencies

Rating agencies also have conflicts of interest since they are engaged as consultants and make money out of the companies whose business they assess and assign bond ratings.

Media

There also exists conflicts in mass media. While established outlets such as The Globe and Mail and The Wall Street Journal have strict codes of conduct and take great care in the publishing of content, the same can’t be said about the media market in general. Some outfits may accept information given to them by corporations without researching it properly in an effort to quickly generate content for revenue-generating reasons.

Other times they have guests and interview people who have a mission to push certain products and stocks. Or they may favour companies that are featured by their guests or sponsors. They may even have a bias in favouring companies in order to have access to certain sources on Wall Street or Bay Street.

Buyer beware

Broadly speaking, the whole stock market business is a marketing machine that just happens to sell stocks, as opposed to pills or groceries. When they want to sell stocks, they promulgate nice stories.

Ergo, everybody in this world has conflicts. That’s why it’s very important for investors to be independent and do their own homework. Alternatively, investors should invest their money with professionals who have skin in the game, meaning they invest a large part of their wealth along that of their clients. This is something value investing professionals often do that helps them overcome the inherent conflicts of interest.

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