Despite regulations, financial analysts say private calls with executives are essential

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A new study of 365 sell-side financial analysts shows that private phone calls with managers remain an essential source of analysts' earnings forecasts and stock recommendations – even in light of regulations limiting businesses' selective disclosure of financial information.

More than half of the analysts surveyed by a team of accounting researchers said they make direct contact with executives of companies they cover five or more times per year. The direct contact with management is so important that one analyst said his company hired an FBI profiler to train analysts "to read management teams, to tell when they're lying, to tell when they were uncomfortable with a question. That's how serious this whole issue has become."

"Everyone who reads our paper comes away with something, but one key takeaway is the importance of private conversations between analysts and managers even in a post-Regulation Fair Disclosure (FD) world," said Lawrence D. Brown, the Seymour Wolfbein Distinguished Professor of Accounting at Temple University's Fox School of Business, who conducted the study with professors at Arizona State University, University of Texas at Austin and Texas A&M.

The survey also finds that accurate earnings forecasts and profitable stock recommendations have relatively little direct impact on analysts' compensation. These findings are derived from a study titled Inside the Black Box of Sell Side Financial Analysts, which presents results of a 23-question survey focused on analysts' incentives, as well as 18 detailed follow-up interviews.

The study offers insights into an area that is understudied by researchers of the financial industry. While hundreds of articles have sought to predict financial analysts' choices using models and statistics, few have peered into the "black box" of the organizational contexts and personal psychologies that drive analysts' decision-making.

The study's findings also serve as a potential commentary on the Securities and Exchange Commission's Regulation Fair Disclosure (Reg FD), launched in 2000 to limit selective disclosure of market-moving information to analysts or other key stakeholders prior to the general public.

But respondents noted that companies' public conference calls discussing quarterly earnings are often followed by one-on-one conversations between analysts and chief financial officers. According to one analyst: "We're almost back to where we were pre-Reg FD, but not quite because that backroom chatter is shut down. It's just now it's not in the backroom; it's everywhere."

More insights from the survey include:

- Approximately one quarter of analysts feel pressured by supervisors to lower their earnings forecasts, presumably because outperforming forecasts pleases investors.
- Approximately one quarter of analysts feel pressured by supervisors to raise their recommendations, presumably because it is easier to get their clients to buy rather than to sell the stocks they recommend.
- While only 35 percent of analysts said the profitability of their stock recommendations were a very important determinant of

their compensation, 67 percent cited "standing in analyst rankings or broker votes" as central to their compensation.
- Only half of analysts considered primary research "very useful" in forecasting earnings or recommending stocks.

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