Prepared written testimony of Gregg S. Hymowitz, a Founder and Principal of EnTrust Capital Inc., for the U.S. House of Representatives' Committee on Financial Services. Testimony prepared for Thursday, June 14, 2001. For the U.S. House of Representative's Capital Markets, Insurance and Government-Sponsored Enterprises Subcommittee's hearing entitled, "Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?" To be presented at 2128 Rayburn House Office Building at 10:00 am.

Mr. Chairmen Oxley and esteemed members of the Committee, I am Gregg Hymowitz, a Founder and Principal of EnTrust Capital Inc., which is an approximately $1.2 billion regulated investment advisory company and hedge fund operator catering to high-net-worth individuals and families. Prior to the founding of EnTrust, I was a Vice President at Goldman Sachs in the private client services group, managing money for individuals.

It is my pleasure to share with you this morning my thoughts and observations on the question of whether Wall Street analysts and their research are biased and if conflicts of interest exist. And what, if anything, could or should be done to improve the process. My comments today represent solely my personal views and not necessarily the views of EnTrust Capital or my partners.

Broadly defined, I believe there are three types of analysts. There are Wall Street analysts whose firms do investment-banking business with the companies they cover; research-only investment houses that often may have a broker/dealer business but do not engage in capital market transactions with the individual companies; and buy-side analysts who typically do not publish research. They may (on occasion) appear in the media with their recommendations.

Most of my comments this morning will focus on the analysts whose firm may be engaged in or attempting to secure an advisory role with the issuer as it relates to potential capital-market transactions.

Is there a conflict of interest among sell-side analysts and the companies they cover? In my opinion the answer is yes. But the relationship between the analyst, issuer, and the investing public is a complex network of checks and balances. The competing interests and needs of each constituent group is ultimately settled in the most efficient marketplace in the world, the stock market. I do not mean to imply that such efficiencies come cheaply—they do not. Hundreds of thousands of individuals (new and old-hand investors) have lost tremendous amounts of capital over the past year.

The conflict the sell-side analyst has is relatively simple to understand. Typically, the analyst works for an investment bank whose bankers are attempting to woo business from the issuer, often in the form of a capital-market transaction, IPO, M&A engagement or other type of advisory position. Therefore, most analysts recognize it does not behoove their firm's self-interest to have a negative view on the issuer or the issuer's sector if their bankers are also vying to pitch business to the company.

Additionally, most analysts' compensation at investment banks has historically been partially determined by the amount of high-margin capital market transaction revenues for which each analyst was responsible. Hence, you have a paucity of outright sell recommendations on the Street.

The communication between analysts and issuers is symbiotic. The issuer needs the analyst coverage to have his or her story told on the Street and to get potential investors interested in buying, and the analyst's life blood is an open communication channel to the issuer. One could surmise that communication is easier and more open between parties when they are aligned. If you are the CEO of a publicly traded company you may be more likely to return a phone call from the analyst who has your stock rated a strong buy sooner than the one who has a "sell at any price" rating on your company.

Given that most sell-side analysts work for broker/dealers, and such firms are in the business of generating trading commissions as a source of revenue, the analyst is often used as a commodity for the broker/dealer whose desire is to entice investors into executing trades through them. The old chestnut about catching more flies with honey than with vinegar holds true here as well.

The pressures and conflicts on the sell-side analyst during the recent equity bubble was exaggerated by the compressed period of time the capital markets were accommodative. Remember, it was roughly during eighteen months that many of these dot-coms were funded. The pressure on investment bankers to win a piece of the pie was enormous—banks couldn't afford to be left behind. Therefore, many analysts confronted added pressures to rapidly understand new business models. An investment bank pitching Internet IPO's couldn't afford to have an equity analyst in the pitch meeting stating he or she was negative on the so-called "space." It just wouldn't fly.

During this market frenzy, investment banks, due to the demand from the investing public and the supply created by the venture capitalists, took hundreds of companies public that in historical terms would never have made it out the door. But the capital markets changed dramatically with the wildly successful offering of companies like Netscape Communications Corporation and Yahoo! Inc.—companies with little or no profits. The need for new valuation metrics became apparent.

For a short period of time, public equity markets during this kinetic period acted more as secondary venture-capital markets. These new markets attracted great enthusiasm because the rewards were potentially huge. Now many investors have learned the painful lesson of investing in public start-ups: While the rewards are potentially much greater, the risks are definitely higher.

Analysts have taken heat on their coverage of these infant industries during the most recent market downturn. Parenthetically, there was little or no public uproar of analysts' rosy coverage in 1999, when many investors were making money in the market hand-over-fist. Much of the current criticism is based on the new methods of valuation analysts and investment bankers created to entice individuals into investing in these immature companies. Free cash flow and earnings metrics were replaced with multiples of sales, developers, and my favorite, Web 'hits!' Now while many of these metrics (in the short run) have turned out to be just plain silly, we need to remember twenty years ago a now widely recognized metric called EBITDA—Earnings Before Interest Tax Depreciation and Amortization—was created to analyze certain companies. At the time they had no earnings. Today cable and media companies have billions in earnings, employ hundreds of thousands, and are some of the largest companies in the world.

There is nothing new about what the equity analyst is doing today albeit in a more frenzied environment. Investment banks have been recommending the stocks of their clients for hundreds of years, roughly since the 1792 Buttonwood Agreement. However, one dramatic change has been who is now receiving this information and how it is being delivered. Historically the "morning call"—where analysts provided daily information to the Street—was the province of the institutional money manager. They understood where this information was coming from and typically was able to evaluate the relative importance of an opinion—particularly whether the analyst giving the information had a reputation of providing competent analysis.

With the rise of the Internet and its accompanying ubiquitous and seamless information flow, Wall Street research calls are everywhere—on the Web, television, radio and print. Recently, with the frenzy of day trading, the analyst calls took on exaggerated importance. Often the trading public seized upon these calls and stocks would move significantly. I believe the institutional manager has always understood these calls as just one person's view, no more—and no less.

When day trading reached epic proportions and the greed was tangibly thick, the analyst calls, to an investing public, became almost as important as the fundamentals of a company. This added another dimension to the potential conflicts analysts have, in that it made the need for the "big call" that much more important. Analysts suddenly started labeling their pieces with bold, creative, and often humorous titles. Anything that created a soundbite or material enough to cause a reaction leading to trading business for their firm or enhancing their influence was fair game.

In a society where every second information becomes exponentially more omnipresent, there are going to be comprehension gaps. For years the institutional money manager understood from where the research hailed, and as it became more pervasive, the individual investor has now caught on. In this age of information overload I believe the individual has the responsibility to perform his or her own due diligence not only on the companies one invests in but also on the analyst chosen.

Currently, there is no shortage of resources available to individuals either online or in the public library when it comes to ways to analyze companies or individual analysts. For decades now *Institutional Investor* has been ranking equity analysts and today there are dozens of free Web sites (*e.g.,* The Motley Fool, Validea.com and TheStreet.com) which rank analysts. These resources, among others, are doing an excellent job of informing those investors who are willing to invest the time in doing due diligence on which analysts to follow. But, for the individual who merely sees the stock market as a craps table and is willing to expend money based upon an analyst's recommendation without doing any of his or her own research on either the issuer or the analyst, does so at one's own peril.

I would also like to address the conflict of the analyst (sell- or buy-side) who appears in the media, whether in print or on-air, recommending the purchase or sale of a security. The potential for conflict is clear—the analyst goes on television talking about a stock that the analyst likes, which he or she owns, and investors go and buy the stock. The stock goes up and the analyst's firm makes money. I do not believe this potential conflict is troubling if certain common-sense precepts are followed.

From the viewer's perspective, the Number One Rule should be *always do your own research.* I believe viewers are better served if the analyst owns the stock he or she is recommending. I would much rather accept advice on a particular stock from someone who has his or her own money in the game. Of course, appropriate disclosure should be made when stating a recommendation.

The news media outlets have done a responsible job in attempting disclosure to their viewers, as much as possible about what their guests own. They have required guests to avoid any appearance of impropriety by not taking advantage of appearances. If anything, the investing public loses the opportunity to hear from many great investors because the burden of having to divulge positions and its concomitant responsibility has limited one's activity prior to and after a public endorsement. This keeps many worthwhile guests away.

Tangentially, one idea that may coerce analysts to be more thoughtful in their recommendation is for investment banks to urge analysts to own the stocks they suggest, so they have their own capital at risk—it is too easy to spend other people's money. With proper internal-trading safeguards to prevent such things as front running, in addition to appropriate disclosure, I believe analysts owning the stocks they recommend may actually help ameliorate any biases that potentially exist. At EnTrust Capital we always say to analysts: Don't tell me what you *like,* tell me what you *own.*

Many individuals want to find a causal relationship between the market's severe correction and the lack of sell recommendations among sell-side analysts. I believe no causal relationship exists. While there have been many buy ratings on the steel, food and consumer nondurable stocks—with little if any sell recommendations—they did not experience the meteoric rise many tech stocks had over the past couple years. It was a confluence of events that caused equity prices of certain sectors to rise disproportionately to the rest of the market—much had to do with Y2K, the Internet revolution, easy monetary policy, and accommodating capital markets. Most important, however, it was investors' appetite for these securities, momentarily short supply, and a shrinking of the equity risk premium. Once each of these events normalized, many of these immature enterprises had no earnings to fall back on. With no cushion in valuation, and capital markets shutting down, these companies went out of business.

Incorrectly, many believe that there are few sell recommendations on Wall Street. There are numerous firms that specialize in providing only sell recommendations. These firms provide an excellent counterbalance. Unfortunately much of this research is not widely circulated to the individual investor because it is costly.

Then there is the cheapest and best research in the world one can do: what I call "walking the mall." The individual investor needs to get out there and do his or her own due diligence. Try out The Gap, buy the latest pair of Nike's, compare the Dell computer to your friend's Compaq. Ultimately the individual is the investor *and* the consumer.

There are also many countervailing pressures on analysts that work toward providing a balanced view. First and foremost on Wall Street, reputation and record mean everything. The analysts over time whom are the most thoughtful, responsible and correct, earn the respect of the investment community, marketplace, and the public at large. Wall Street is a humbling place: You can be a star one day and a has-been the next. It's only with mindful research over a period of years the analysts really earn their stripes. It is this institutional pressure for analysts to be correct that is the largest force compelling honest work.

One clear way of holding analysts accountable is for the investment banks to publish each analyst's performance record, based on his or her recommendations. This would provide more information to the investors and aid those who are superior stock pickers.

While some have toyed with the idea of separating the research department of sell-side firms with the investment-banking department, I believe this idea to be unwise, impractical, and commercially nonviable. Lest we not forget, most of the conflicts I have presented are either now well known to the investing public or disclosed by the investment banks. Such disclosure language is often longer in length than the actual research.

I would rather see investment banks improve disclosure by making it more material. Instead of providing two pages of gibberish—in order to avoid lawsuits—provide investors with concise material disclosure statements. It is more important from a potential conflict standpoint to know if the bank is currently engaged by the issuer or is pitching the firm new business, rather than the typical historical disclosures.

The disclosure statements should consist of whether the analyst personally owns the security. As I stated previously, equity ownership by analysts is a positive occurrence, not something to be shunned. The public company may consider whether or not it should disclose when it has engaged a currently publishing investment bank. Such disclosure could be accomplished without getting into the specifics of the engagement and thereby not affecting the commercial realities of its business.

The new information age combined with Regulation FD—Fair Disclosure—is impacting the role of the analyst. With companies now severely limited to what they can say to analysts prior to generally released news, the importance and edge that analysts have over the investing public as it relates to any individual issue has significantly diminished. Therefore, many analysts are now utilized less for expertise on a particular company and more for their knowledge of a particular sector. Sector research, while not devoid of potential conflict, is clearly less prone to bias.

In today's new Regulation FD-world the usefulness of the analyst is confined by the quality and quantity of the information issuers are providing to the public. While this is not a forum on issuer disclosure, it is my opinion that the lack of uniformity in such information ultimately leaves the investing public with only half a knowledge deck. While there are standard SEC filings required, often the most valuable information comes from other sources in which there appears to be no set standards.

Investing is as humbling as golf. Every day is riddled with mistakes. Unfortunately, often the only way to learn in this business is from mistakes and that costs money. Investors have learned a hard lesson: with huge rewards come equally huge risks. The bubble has burst. Just as there was the 1636 Dutch tulip boom, the 1828 French cotton craze, so too, is there the most recent, the biotech and Internet bubbles. There will be other manias with new and probably ever-more-fanciful valuation metrics in our future. Investors should not believe everything they read, hear or see. In the new Regulation FD Internet-age the playing field has been leveled, and therefore the responsibility must accordingly be shared.

Thank you.