How Merrill Lynch boosted "junk" stocks

Nick Beams
16 April 2002

First it was Enron, once rated among the top ten US corporations. Then as questions were being asked as to how “off-balance sheet” dealings were used to boost profits, the company’s auditor, Arthur Andersen, among the top five US and global accounting firms, shredded Enron-related documents. Now the spotlight has been turned on one of the biggest names on Wall Street, Merrill Lynch.

Last week, New York State’s attorney general, Eliot Spitzer submitted a 37-page affidavit resulting from a 10-month investigation which alleged that stock analysts at Merrill Lynch were recommending Internet stocks that they privately derided.

According to a press release announcing court action against Merrill, due to commence this Friday, “the firm’s stock ratings were biased and distorted in an attempt to secure and maintain lucrative contracts for investment banking services. As a result, the firm often disseminated misleading information that helped its corporate clients but harmed individual investors. Spitzer described the case as “a shocking betrayal of trust by one of Wall Street’s most trusted names.”

There was a “major breakdown in the supposed separation between the banking and research divisions at Merrill Lynch,” the statement continued. “In fact, analysts at Merrill Lynch helped recruit new investment banking clients and were paid to do so. The public, however, was led to believe that research analysts were independent, and that the firm’s rating system would assist them in making critical investment decisions.”

Spitzer bases his allegations on an examination of more than 30,000 internal e-mails. This disclosed stark differences between recommendations to clients and private opinions on shares. Shares given a “buy” recommendation were described in terms such as a “piece of junk”, and a “piece of shit”.

In one case, the head of Merrill’s Internet research team, Henry Blodget, who left the company last year, was advising investors to buy InfoSpace shares even after they had passed their peak of $132 in March 2000. Privately, he described the stock as a “powder keg.”

Even more revealing is the case of Internet wireless operator Aether Systems Inc, which was a big investment banking client of Merrill Lynch.

Merrill Lynch was the lead underwriter for Aether’s initial public offering in October 1999 and two further stock offerings. For selling Aether stocks and bonds underwriting firms collected a total of $88 million in fees, with Merrill, as the lead underwriter, taking about half. Aether stocks hit a high of $315 in March 2000 and then started to fall. But Merrill continued to recommend the stock even as it plunged by 90 percent. It now trades at around $4 a share.

According to documents filed by Spitzer: “The conflicts and pressures that the research team experienced became particularly acute at the end of 2000, with respect to the mobile Internet company, Aether Systems.”

The problems began when, in the course of a telephone conversation, a member of Blodget’s team recommended another company, Phone.com, as having the “best real business opportunity” in the Internet wireless business. This conflicted with the written position of the research team which said there was “no other player in this space with as much breadth and dominance” as Aether.

By December 2000, it appears the research team wanted to downgrade the whole sector but was afraid to do so because Aether was a major client. During an internal discussion on whether to lower ratings where this could cost Merrill investment banking business, Blodget wrote: “If there is no new e-mail forthcoming ... on ... sensitive banking clients/situations we are going to just start calling the stocks, including AETH, like we see them, no matter what the ancillary business consequences are.”

Calling stocks "like we see them" was what investors were led to believe the stock analysts were doing in the first place.

According to Spitzer, the problem went far beyond a single analyst, with pressure being applied from the top down. At one point the head of the equity division wrote to analysts: "We are once again surveying your contribution to investment banking ... please provide complete details on your involvement ... paying particular attention to the degree your research played a role in originating ... [banking business]."

One research analyst apparently complained about giving a buy rating to a poor investment: "I don't think it is the right thing to do. John and Mary Smith are losing their retirement because we don't want a client's CEO to be mad at us."

No one yet knows how far the rot extends, but already the Merrill Lynch case is being described as the tip of the iceberg. Spitzer is reported to have issued subpoenas to most of the major investment firms, including Credit Suisse First Boston, Salomon Smith Barney, Goldman Sachs, Morgan Stanley, Bear Stearns, UBS Warburg, Lehman Brothers and JP Morgan, demanding that they turn over e-mails and other communications involving stock analysts and investment bankers.

In addition to "share advice" and its relationship to investment banking operations, there is the question of the manipulation of profit figures. Here, in the aftermath of Enron's demise, Xerox is another big name firm to come under scrutiny.

Last week it handed over a record $10 million in a civil penalty to settle a case with the Securities and Exchange Commission described by officials as one of the largest cases of financial fraud they had ever seen.

The central allegation—neither admitted nor denied by the company—is that when the company's profit results looked as though they would fall short of analysts' earnings forecasts, a fairly frequent occurrence, it would use one-off accounting tricks to "close the gap".

The Xerox announcement last Thursday came on the same day that IBM stocks were sent plunging on rumours, denied by the SEC, that it was the subject of an investigation. General Electric is another firm whose shares have fallen on fears that its real earnings in the 1990s were not as they had been reported.

It is impossible to fully gauge the extent to which "aggressive accounting" methods have been used to inflate the profits and stock prices of major companies, but national accounts figures provide some indication.

These show that pre-tax profits for non-financial corporations as a percentage of gross domestic product reached a cyclical peak of 12.8 percent in the third quarter of 1997, falling to 10.4 percent in the third quarter of 2000 and 7.5 percent in the third quarter of 2001. Yet over this same period—particularly before the collapse of the stockmarket bubble in April 2000—companies were reporting record profit increases. Since then the reported profits of companies in the S&P 500 index have plunged by 20 percent, the biggest fall in the post-war period.

What these figures imply is that the inflated profit results of the late 1990s, on which the incomes and payouts of top corporate officials were based, amounted to nothing less than systematic looting.

Longer-term data produced by the National Bureau of Economic Research show that the "creative accounting" methods formed part of a wider process in which, for the past quarter century, wealth has been progressively sucked up the income scale.

Data prepared by the National Bureau of Economic Research (NBER) reveals that average annual income adjusted for inflation rose by only 5 percent between 1973 and 1998. However, over the same period average income for *Fortune* magazine's 100 top-paid executives increased by 500 percent.

This result reflects broader trends. According to the NBER, 94 percent of the growth in average annual income since 1973 has gone to the top 1 percent of income earners, that is, anyone making above $684, 378 in 1998. One of the ways in which this transfer was carried out was via escalation of share prices using the kind of methods now coming to light.