CornerCap
INVESTMENT COUNSEL

Enron: A Lesson in Wall Street's Objectivity

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On whom should one rely for investment advice? With the creative accounting that many companies use to beautify their financial statements, it takes an incredible amount of time and effort to understand the numbers. Many managers depend on Wall Street securities firms for this research. These are well-established firms such as Merrill Lynch, Salomon Smith Barney, Morgan Stanley Dean Witter, etc. It is important to understand why almost all of the analysts at these firms had positive ratings for Enron in the months before it went bankrupt. If this were understood, then people would know why CornerCap has never relied on Wall Street research.

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The cash cow for Wall Street securities firms is underwriting deals. Research is a loss leader. It is in the securities firms' best economic interest to push their research analysts to support actively the stocks and bonds of the companies that the firms may underwrite in the future. Tout a company that becomes a big underwriting, and the research analyst may receive a significant bonus. Bash a company that shuts the firm out of a big underwriting, and there will be no bonus and possibly no job. This is not complicated; just follow the money. There is no way that these analysts can be totally independent and objective.

A good example was Daniel Scotto, a bond analyst with BNP Paribas. On August 23, 2001, he lowered his rating for Enron bonds from "buy" to "neutral," and further noted in his research report that investors consider using the sale of Enron securities as a source of funds. For job security, he chose not to rate the bonds a "sell." Mr. Scotto followed up the research report with a conference call where he was more blunt about his recommendation. The phone call was recorded since it was from the trading floor. A few days later, he was told that his recommendations did not seem reasonable and that he was immediately demoted and placed on family leave so he could "cool off." While on leave, the company advised him that he was terminated. There was economic pain and no benefit to Mr. Scotto for his objectivity.

One by one, independent investment research firms have disappeared. Research is now sold or "given away" by Wall Street firms that sell other conflicting products. When markets are roaring as they did during the 1990s, no one feels the need to pay for independent research. In bear markets, investors are more willing to pay for independent advice. We do our own research, and it has always been independent. This philosophy has and will continue to enhance our performance.

Tom is CEO and Chief Investment Officer of CornerCap Investment Counsel. He and Gene Hoots co-founded the firm, which was incorporated in 1989. Tom is also President and Treasurer of the CornerCap Group of Funds. His previous positions included being Chief Investment Officer of RJR Investment Management, Inc., the investment advisory subsidiary of RJR Nabisco, and a consultant for Arthur Andersen & Co. He is a Chartered Financial Analyst (CFA) Charter holder and a member of the Association for Investment Management and Research (AIMR) and the Atlanta Financial Analyst Society (ASFS). He is a Certified Public Account (CPA) and a member of the American Institute of Certified Public Accountants (AICPA). He has two graduate degrees, an MS in Industrial and Systems Engineering from Ohio University and an MBA from the University of North Carolina at Greensboro.

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