DO ANY ANALYSTS STILL ANALYZE?

WHEN SCOTT CLELAND headed up a special telecommunications research group at investment bank Legg Mason (LM), he enjoyed a reputation as an informed and oft-quoted analyst. A former State Department trade policy analyst and Booz Allen & Hamilton consultant, Cleland, 40 years old, joined Legg Mason in 1997.

When he was at the Baltimore-based bank, mutual fund companies like Roger Engemann & Associates used Cleland's research to navigate the shifting landscape of telecom mergers, tax structures and markets. "He's really tied in to what's going on in telecom regulation," says Ned Brines, portfolio manager of the Phoenix-Engemann Growth fund (PASGX). "He's one of the thought leaders," echoes Jeff Kagan, who follows telecom trends at his own firm. The buzz had it that Legg Mason thought Cleland to be such a rising star that he was allowed to hand-pick his own staff and run his shop independently of the rest of the bank.

Yet late last month, Cleland took his eight-member staff and bolted Legg Mason to form his own boutique research firm. No, this wasn't a case of a successful underling starting his own business to make a little more money. Rather, Cleland says, he left Legg Mason to establish the Precursor Group because he was increasingly bothered by what he saw as an industrywide breach in the so-called Chinese Wall between investment banking and research.

"The average investor should know that company research is written from the perspective of selling the company," says Cleland. He says that analysts all too often write research reports to promote stocks and draw clients to the banking side of an investment bank's business. That means, he says, that analysts "tend not to emphasize the warts."

This isn't exactly news. Any sophisticated investor will tell you that the conflict is both recognized and obvious. But when someone of Cleland's stature calls attention to the issue, and says goodbye to his successful career at a respected bank, it makes you think twice about the quality of research most investors receive.

Though Cleland says he had been aware of this conflict for some time, his breaking point came last year. While writing reports about the battle between cable companies and America Online (AOL) over how consumers would access the Internet in the future — cable modems vs. digital subscriber lines — Cleland surmised that AOL would win out. Cable companies, in turn, charged that Cleland's report was biased since Legg Mason owned AOL stock. He decided to form his own firm, with no banking business to speak of, so that he would never have to deal with that conflict again.

The conflict of interest at investment banks arises because banks have to compete furiously for the opportunity to advise companies on stock offerings and mergers. Meanwhile, the rise of free information on the Internet has shrunk the fees banks can charge clients for research. (Lehman Brothers Holdings (LEH), for example, has a deal to provide research free of charge to Fidelity investors.) Research itself doesn't make money; banking and initial public offering fees do.

Brown Brothers Harriman provides a good example. The last of the big New York investment-banking partnerships, Harriman had to shut down its research unit in May because the bank couldn't cover the unit's
costs. So if banking and proprietary trading cover an analyst's salary, and an analyst is steeped in the more-more-more money culture, what's he going to do in his research besides try to spur more investment banking? The result, Cleland says, is that investors are getting compromised research.

Cleland also points out that changes in the way companies provide information to the public have further diminished the quality of research. In the past, it was common for analysts to get tips on company earnings and prospects before that information became public. But in an era of financial news sites like this one and instant world-wide emails, the Securities and Exchange Commission recently proposed that companies make all their information public to everybody at the same time.

The move was supposed to prevent big players from benefiting from insider information. But Cleland says it has simply resulted in less information all around. "It's no surprise that there are stock surprises all the time now," he said in an interview last week. "If you had a more open system, where people were encouraged to do more research early rather than wait at the trough for Investor Relations to slop out press releases, [you would have] continuous aggressive digging by everybody. If everybody has to be present at the discovery of every rock that's turned over, it's sort of like saying the only research that can be done is on TV or in a stadium."

Cleland's boutique firm doesn't do investment banking or trade stocks for clients. Instead, Cleland says his small company will make the majority of its revenues by executing trades for institutional investors. A smaller part of his company's sales will come from research subscriptions. Cleland hopes that building his business on fees from trades, rather than banking or investment management, will make Precursor's research as impartial as possible.

Researchwise, Cleland plans to take on macro issues in the telecommunications and technology sectors rather than focus on individual stocks. Don't count on an earnings prediction out of Precursor. But you can sure expect to hear what cell-phone penetration might be in India by 2009.

The institutional clients who buy Wall Street research seem to agree with Cleland's critique. "I was doing the Institutional Investor poll [of star Wall Street analysts] a few weeks ago," one fund manager told me, "and I could hardly think of anybody to vote for, because hardly anybody is doing research anymore. Everybody is doing banking deals."

It isn't just superstars like Jack Grubman of Salomon Smith Barney or Mary Meeker of Morgan Stanley Dean Witter who (reportedly) drum up investment-banking business. Any analyst from any bank could be conducting research with future underwriting contracts in mind.

And if that makes you feel at all uncomfortable, Scott Cleland would like you to be his customer.

-- By Alec Appelbaum