Faulty Ratings: How Analysts Fueled the Internet Bubble

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Using mostly primary sources, this paper examines how Internet analysts encouraged irrational speculation in the late 1990s and early 2000s. The paper begins with a description of Kindleberg's theory of financial crises and relates it to the Internet bubble. Section I of the paper focuses on the role of the analyst, and Section II and III examine two analysts in particular — Henry Blodget and Mary Meeker. Section IV transitions to how the media amplified analysts' voices, and section V concludes the paper's body by examining the aftermath of the Internet bubble and reforms in the field of Wall Street research.

I. Introduction

In early 2001, New York pediatrician Debasis Kanjilal filed a legal complaint with the U.S. Securities and Exchanges Commission (SEC).[i] Kanjilal alleged that he had lost $500,000 following the advice of Merrill Lynch's star investment analyst Henry Blodget.[ii] When Kanjilal attempted to sell his shares following the burst of the Internet bubble in the spring of 2000, a Merrill Lynch broker dissuaded him citing Blodget's reports, which later proved inaccurate and full of advice Blodget himself did not believe.[iii] Later, an Ohio couple would also sue Merrill Lynch for incorrect investment advice on Internet stocks.[iv] Cases like that of Kanjilal and the Ohio couple brought to light the role that Internet stock analysts had played in creating the Internet bubble. Rather than conducting objective analysis, analysts almost always rated companies positively to attract underwriting business to their investment banking division. By involving themselves in less analysis and more salesmanship than ever before, analysts provided faulty ratings and fueled the irrational speculation of the late 1990s stock market bubble.

In his famous work *Manias, Panics, and Crashes*, Charles Kindleberger notes that speculative bubbles are "triggered by market shocks such as major technological change."[v] After the initial phase of rational speculation, the market enters a period of speculative mania during which investors adopt a "Devil take the Hindmost" attitude.[vi] As for the Internet bubble, the Internet was the market innovation associated with speculation. Mary Meeker's inaugural Internet Report in 1995 correctly predicted that although less than fifteen million people Americans were connected to the Internet at the time, nearly 150 million would be connected to the Internet by the end of the century, creating an explosion of human potential and wherewithal; the value of a network, after all, increases in proportion to the square of the number of people using it.[vii] Bill Gates remarked that "business would change more in the next ten years than in the last 50."[viii] As people came to see the Internet as being at the helm of a

social and industrial revolution that would fundamentally "change the very way in which companies do business," the market turned from rational to irrational speculation.[ix]

In many ways, Netscape's 1995 Initial Public Offering (IPO) was the beginning of the Internet stock mania that would last until the spring of 2000.[x] Although it had no profits, Netscape's incredible buzz and futuristic services — a web browser — propelled it to one of the best first-day tradings in history.[xi] The company's IPO alerted Internet entrepreneurs, the investing public, the media, and Investment Banking companies to the promise of the Internet on the stock market. People came to believe that New Economy rules would apply — one in which companies were not judged by their balance sheets, but rather by Web site page views or revenue growth.[xii] At the center of the "buzz" and New Economy rules were the propagators: analysts.

II. Role of the Analyst

Once viewed as between retail brokers and the cafeteria staff on the Wall Street totem pole, research analysts saw their role grow as the SEC loosened its enforcement of the Glass-Steagall Act.[xiii] As firms like J.P. Morgan and Chase Manhattan and Morgan Stanley and Dean Witter merged, the traditional line between retail brokerages and investment banks became blurred.[xiv] Analysts, who were previously only responsible for recommending stocks at retail brokerages, took on the role of helping companies go public and marketing their stocks to the public — something previously reserved for investment bankers.[xv] The "Chinese Wall," or divide between the analysts and the firm's big money-makers — the traders and the bankers — soon disappeared.[xvi] Analysts now routinely interacted with traders and bankers, and increased responsibilities led them to be labeled the firm's "rainmakers.'"[xvii]

Since they needed to secure underwriting business for their investment banking colleagues and market stocks to the public, investment analysts exposed themselves to a major conflict of interest. In order to attract underwriting business and take companies public, analysts rated companies positively and encouraged investors to purchase shares in the corporation. Since rating a company poorly would discourage it from working with the analyst's firm in the future and scare off other potential partnerships, analysts were extremely reluctant to downgrade companies. Instead, analysts competed amongst each other to see who could make the highest predictions as to what price a company's stock would reach.[xviii] "Research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow," remarked Stefan D. Abrams, chief investment officer (CIO) for asset allocation at the Trust Company of the West in Manhattan.[xix]

III. Henry Blodget: "The Fair-weather Forecaster"

One of the biggest culprits of outlandish price targets was Internet stock analyst Henry Blodget. Although most technology analysts on Wall Street had attended business school, Blodget only carried a history degree from Yale.[xx] After his ambition to be a journalist went no further than a job as a fact checker for *Harper's Magazine*, Blodget became a Wall Street trainee, worked as an analyst, and bet his career on the rise of the Internet.[xxi] On December 16, 1998, Blodget made the call that would earn him celebrity status in the financial world. While most analysts — such as Merrill Lynch's Jonathan Cohen — predicted Amazon's $242 stock price would fall, Blodget boldly predicted that the Internet-based retailer's shares would hit $400 a piece. Three weeks after Blodget's prediction, Amazon's shares hit $400.[xxii] Several weeks later, Blodget was hired to take Cohen's position.

Financial pundits and the media alike proclaimed Blodget's superstar status, and the influential magazine *Institutional Investor* named Blodget its top-ranked Internet analyst in 2000.[xxiii] Riding on his newfound fame, Blodget maintained his fair-weather predictions and marketed them in the media. Through 1999 and well-into 2000, all of Blodget's stock ratings were "buy" (20% or more growth expected) or "accumulate" (10% or more growth expected) — the two highest ratings an analyst could give.[xxiv, xxv] Initially, as the speculation mania raged, Blodget seemed to meet his predictions. When the bubble burst on March 11, 2000, however, Blodget ran out of luck. By the summer of 2000, it was clear that the public could not trust Blodget for investment advice. Blodget's recommended portfolio for the year 2000 had an average return of -54.2 percent, with only one stock gaining value.[xxvi] CMGI, a company Blodget had advised investors to "accumulate," fell from a high of $100 in in early 2000 to below $3 by the summer of 2001.[xxvii] Internet Capital Group, a company Merrill Lynch took public, fell from a high of $225 to $3.25 within a year.[xxviii] Pets.com and eToys, two startups in Blodget's portfolio, failed before every turning a profit.[xxix] Blodget had misled millions of investors, and in the

process, ruined what was supposed to be savings for these people. Many workers could no longer retire as planned, send their children to college as planned, or take the vacation they believed their investment profits would give them. As Abrams, the Trust Company of the West's CIO put it, "the customer who followed the analyst's advice is paying the price."[xxx]

Blodget's poor ratings, however, were not accidental; rather, they were the result of pressure from Merrill Lynch to rate stocks highly in order to market them and recruit more underwriting business. Although not explicitly written out, it was well-understood that all analysts were not permitted to issue negative opinions about investment banking clients.[xxxi] Analysts were paid largely on the profitability of their investment banking unit, and investment bankers at Merrill often had a say in analysts' bonuses.[xxxii] Contrary to the image of objectivity they projected, Merrill Lynch analysts "knowingly compromised their honestly held beliefs and [...] often initiated, continued, and/or manipulated research coverage for the purpose of attracting and keeping investment banking clients," stated the Spitzer Report, a brief produced by New Attorney General Eliot Spitzer as he investigated the conduct of investment analysts during the late 1990s.[xxxiii] As a result of internal policy, analysts did not issue "reduce" (10% percent to 20% price drop expected) or "sell" (20% or more price drop expected) ratings.[xxxiv] The list of covered Internet stocks for the second quarter of 2000, for instance, lists 24 stocks, none of which were rated less favorably than "accumulate."[xxxv]

When Blodget's colleague Kirsten Campbell concluded that GoTo.com, an Internet advertising company that was accruing heavy losses, deserved a negative rating, Blodget responded by suggesting Campbell revise her recommendation to a "2-2" rating — a short-term and long-term "accumulate."[xxxvi] In other words, Blodget wanted Campbell to rate a company whose price she expected to fall as having a 10 to 20 percent growth opportunity. Campbell's response to Blodget was telling. "I don't want to be a whore for f-ing management," she wrote in an email. "If 2-2 means that we are putting half of Merrill retail into this stock because they are

out accumulating it then I don't think that's the right thing to do. We are losing people money and I don't like it. John and Mary Smith are losing their retirement because we don't want Todd [GoTo.com's Chief Financial Officer] to be mad at us.'"[xxxvii]

Campbell's effort to secure independence from the investment banking division was futile, however. Blodget's team had helped produce a hundred million dollars in investment banking revenue from December 1999 to September 2000, and Blodget would not stop because of his Campbell's moral quandary.[xxxviii] From the spring of 1999 to the fall of 2001 — more than a year after the bubble burst — Merrill Lynch never published a single "reduce" rating, despite believing otherwise.[xxxix] In email threads, Blodget and his team referred to 24/7 Media, which was rated a long-term "buy," as a "piece of shit.'"[xl] Despite recommending Internet Capital Group as a long-term "buy," Merrill Lynch analysts believed — and correctly predicted — that the stock would "go to 5 [dollars].'"[xli]

IV. Mary Meeker: "Queen of the Net"

The other big Internet analyst of the era, Morgan Stanley Dean Witter's Mary Meeker, did not provide recommendations contrary to her opinion; rather, Meeker became too involved in Morgan Stanley's investment banking relationship with the companies she dealt with and was unable to separate her personal views from the "objective" recommendations she was supposed to provide. Dubbed the "Queen of the Net" by *Barron's*, Meeker came to see herself not only as an analyst but also as a power broker and dealmaker.[xlii] "I don't think of Mary as an analyst. I think of her as a service provider for investors, entrepreneurs, and management teams," said Kleiner, Perkins, Caufield and Byers venture capitalist John Doerr.[xliii]

During the dot-com craze, Meeker was by far the most important voice for the Internet — the media, corporations, investing public, and celebrities alike sought out Meeker's recommendations as though she was a divine prophet.[xliv] After having discovered Netscape and persuaded then-Head of Morgan Stanley's Investment Banking Group Frank Quattrone to underwrite the startup's IPO, Meeker published the inaugural Internet Report, which would become the Bible for the field of Internet stock investing.[xlv] Meeker popularized the notion that companies had to sacrifice profits for rapid growth and that companies without earnings had large potential.[xlvi] By 2000, Morgan Stanley had a fund called the Internet index, in which all 29 stocks were chosen by Meeker and her team.[xlvii]

While Blodget simply churned out positive recommendations for companies that Merrill Lynch's banking team had partnered with, Meeker was particularly aggressive in identifying promising companies and helping the banking team turn these companies into clients. Meeker sat in on banking strategy sessions, courted prominent companies, and implicitly promised to support the companies Morgan Stanley took public with favorable research.[xlviii] If Meeker saw that a company had a large potential market, was using clever technology, and had recruited an experienced management team, Meeker threw her support behind the company.[xlix] In 1999,

Meeker helped Priceline.com, which had lost $140 million just the year before, achieve a valuation of 11 billion dollars — as much as that of American Airlines.[l] Since Meeker was so tied to recruiting companies to Morgan Stanley and taking them public, she also felt bound to how their stocks performed. For example, Meeker maintained a positive rating for Priceline.com's stock until March 2002, when the stock had fallen almost ninety-seven percent from its peak value of $162.[li]

As her fame increased, Meeker began creating her own financial and nonfinancial metrics to support the companies Morgan Stanley had taken public. By 1996, Meeker's recommendations included the novel metric "discounted terminal valuation," which was based on anticipated margins and growth rates five years down the road.[lii] By 1998, Meeker had started valuing companies based on "eyeballs" and "page views." In a report on Yahoo, entitled "Yahoo, Yippee, Cowabunga …," Meeker asserted that "forty million unique sets of eyeballs and growing in time should be worth nicely more than Yahoo's current market value of $10 billion."[liii] Just four months later, the fact that Yahoo's pageviews had risen 25% topped Meeker's "five key financial highlights" — above revenue growth and changes in expenditure.[liv] As the 20th century came to a close, it no longer seemed that Meeker was following her "Ten Commandments for Investing in Technology Stocks," particularly that one should "sell when everyone is interested in technology (or when attendance at technology conferences reaches record levels or when your grandmother wants to buy a hot technology IPO)" or only buy "when fundamentals are intact."[lv] "She was flying at 50,000 feet, talking about trends. She had no idea what the fundamentals were," commented one banker.[lvi] By 2001, three of the companies Meeker was most vocal in her support for — Amazon, Yahoo, and FreeMarkets — fell between 85 to 97 percent from their peak value.[lvii] Meeker's actions highlighted how divorced analysts were from reality; instead of formulating recommendations based on research, analysts created research to support their preconceived recommendations.

V. The Media's Role in Amplifying the Analyst's Voice

Part of the reason these analyst recommendations were so harmful was that they were amplified by the media. Publications created indexes that tracked the performance of the best-performing technology stocks of the late 1990s.[lviii] Reporter after reporter wrote favorably about IPOs on the assumption that new offerings would continue to proliferate.[lix] Stock predictions by analysts were reported on as fact rather than as opinion.[lx] Kevin Kelly, the founding executive editor of *Wired* magazine, promoted the idea of the Internet as a future with limitless opportunities.[lxi] People, as *The New Yorker*'s Michael Wolff wrote, began to feel like the "e-boom" was different from a regular boom; a Wall Street banker was quoted telling Wolff, "journalists create decades, but technology creates epochs."[lxii]

Perhaps the media organizations that fanned the flames of the speculation bubble most were CNBC and, ironically, the non-profit Public Broadcasting Station (PBS). Noticing that their viewership increased when they promoted stocks, CNBC consistently featured bullish analysts on its shows. Flip-flopping analysts — or those who alternated between negative and positive recommendations of particular stocks — were pilloried and labeled penguins on-air. Analysts, like Henry Blodget and Mary Meeker, were treated as superstars and not questioned on their conflicts of interest. "Squawk Box," telecast from 7 a.m. to 10 a.m. on CNBC, functioned as the "SportsCenter" of the financial world. Anchorman Mark Haines reported business news mixed with entertainment news on set and intermittently cut to reporter Maria Bartiromo, who provided live updates and market trends from the New York Stock Exchange trading floor. PBS' "Wall Street Week," hosted by the patrician-like Louis Rukeyser, was known for its upbeat analysis of the market. Out of Rukeyser' five-member panel of market "elves," only one, Gail Dudack, was considered a "bearish" analyst during the dot-com bubble. Dudack was fired at the end of 1999 after Rukeyser became intolerant of Dudack's negative

recommendations. Egged on by publications and the television media, small investors rushed to join the Internet frenzy. Even if these investors could not lead the revolution, they wanted a stake in the revolution.[lxiii]

As investors rushed to engage in speculation, Internet entrepreneurs became more eager to IPO as soon as possible. Having seen companies such as Amazon, Netscape, and Priceline.com succeed tremendously on the stock market without turning profits, many Silicon Valley creators came to believe their company was "the next big thing." Meeker herself seemed appalled about these entrepreneurs' attitude, saying, "They were unbelievably arrogant about how successful they were going to be, and they were unbelievably arrogant about the valuations they wanted to achieve on their I.P.O. I was just pissed. I was, like, 'Come on, guys,' The first generation was, like, 'Hey, isn't this great! I'm a billionaire! Well that's kind of embarrassing. What am I going to do with all this stuff? The next generation is saying, 'Well if he's a billionaire, then I've gotta be a billionaire.' With every I.P.O., the envelope is pushed a little further. At some point you have to scream 'uncle.'"[lxiv]

These entrepreneurs prodded Wall Street to take their firm public, and Wall Street, sensing financial opportunity, gladly accepted. Along the way, Wall Street and the companies going public ensured that analysts would give them positive ratings and retain these recommendations. This, in turn, encouraged more companies to seek IPOs, more media coverage, and more market speculation.

VI. Bubble Burst, Prosecuting the Culprits, and Embracing Reform

By the time the Internet Bubble burst in the Spring of 2000, many of the startups that had conducted IPOs had accrued losses and could no longer sustain themselves as independent companies. As companies shut down, investors panicked and fled the stock market, causing a dramatic fall in stock prices. Over the next two and a half years, the NASDAQ fell three-quarters from its peak value of 5048 on March 10, 2000.[lxv] The Internet bubble burst also destroyed $6.2 trillion in household wealth over the next two years.[lxvi]

Almost immediately, New York state Attorney General Eliot Spitzer, the SEC, and the U.S. House Committee on Financial Services opened investigations regarding the cause of speculation and the subsequent bubble burst. Spitzer, who earned the title "Sheriff of Wall Street" for punishing those who caused the early 2000 stock market crash, brought to light the misdeeds of Internet analysts in his infamous "Spitzer Report." Less than three weeks after Spitzer's team published a report highlighting Henry Blodget and his team's actions, Merrill Lynch's stock-market valuation fell by more than five billion dollars.[lxvii] To stave off bankruptcy and avoid a court case, Merrill Lynch agreed to a series of reforms put forth by Spitzer: (1) the firm would pay a $100 million fine, (2) its analysts would be paid only for providing services intended to benefit investors and not the investment banking business, (3) the firm would appoint a committee to review its research practices, and (4) the firm's compliance department would ensure that there was no contact between analysts and investment bankers.[lxviii] Within weeks of Merrill Lynch's settlement with the New York state Attorney General, ten of Wall Street's biggest banks also agreed to Spitzer's terms.[lxix] By settling with Spitzer, the banks avoided prosecution and further investigation by the SEC and the Committee on Financial Services.[lxx]

VII. Conclusion

Put simply, the Internet bubble was a case study in how the market became divorced from underlying values in the face of new technology. Awed by the promises of the Internet, investors flocked to Internet stocks, driving up demand for Internet company stock offerings. As demand for Internet companies' stocks rose, investment banks began to compete for the companies' underwriting businesses. To secure stock offerings, investment banks pressured their research analysts to issue positive ratings and market the companies they took public to investors. Knowing that their pay and job security was contingent on how well their firm's investment banking business did, research analysts involved themselves in less analysis and more salesmanship than ever before. Most investors, with little stock picking knowledge but a desire to get rich, adopted the "objective" ratings analysts provided. As investors gobbled up shares, demand for new stock offerings stayed constant. Investment banks continued to issue IPOs, and stock analysts found themselves forced to come up with creative ways to justify purchasing companies with large losses and little market share. As a cycle of speculation developed, it became hard for any one particular agent to exit the market. As Citigroup CEO Charles Prince said, "as long as the music [was] playing," all analysts could do was "get up and dance."

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