The irrational exuberance of analysts

N OCT 20, Citic Pacific announced an estimat-ed loss of US$1.9 billion as a result of wrong for-sign survey bets that were allegedly made by finance executives without proper authorisation. The stock price promptly fell by more than 50 per cent.

If we look at analysts’ recommenda-tions on Citic Pacific as reported in Reuters.com as of Oct 24, there were two “buy”, four “outperform”, two “hold”, two “underperform”, one “sell” and one “no opinion”. Such diversity of analysts’ recommen-dations is extremely common, even for a stock that has just tanked badly.

Of course, some analysts expect things to get better, and hence their “buy”, “out-perform” and “hold” recommendations. If we go back one month ago, before the los-ses were revealed, the distribution of recom-mendations was remarkably similar – three “buy”, four “outperform”, two “hold”, two “underperform”, one “sell”, and one “no opinion”. Going back two months and three months, the distribu-tions of recommendations were also very similar.

In the meantime, over those months, the stock price has fallen from above HK$380 to just over HK$5.

Of course, different analysts will have different views about a stock at any particu-lar time, based on their own research and methodologies. However, an investor must wonder which analysis’s recommen-dations to follow, given that at any one time, the recommendations will often span the entire range of possibilities. Ac-cording to Reuters.com, the average ratings for the analysts for Citic Pacific were co-incidently just over 2.50, based on a range of one to five over the last three months up to now – which translates into something between a “hold” and an “outperform”.

Hence, many analysts are left to work hard to maintain a clear view of the company, and they often have to adjust their ratings based on new information.

Therefore, the analysts’ recommenda-tions were generally on the positive side, while the stock had by more than 80 per cent. Contrast this lack of accountability for analysts’ recommendations with the issue of an opinion by an author. If an author issues a clean opinion and the company imposes shortly after, he/she will usually be pointed at the author. To be fair, an a-nalyst is paid a lot more than an auditor to con-duct an audit and issue his opinion, so it is reasonable to expect a high quality of work, although the auditor is also heavily reliant on the information provided by the client.

It is right that analysts should be held accountable if they are clearly in their own work. It may be useful to also make ana-lysts more accountable for the quality of their research. Perhaps the track record of analysts should be made more transparent to the market.

What is perhaps more disappointing is that in making their recommendations about a company, few analysts seem to consider the potential government red tape that could affect the quality and sustainability of the earnings of the company, or even whether the earnings are real or faincysy.

Last year, I was invited to chair a panel discussion on corporate governance at a major conference organised by an invest-ment bank and attended largely by ana-lysts and fund managers. It was a surreal experience.

In our session, we were discussing con-cerns about corporate governance in Asia and were rather critical. However, the mood of the other sessions was consistent-ly upbeat and corporate governance was hardly mentioned. I felt like I was attend-ing a wake and had accurately stumbled into a wedding dinner.

Let’s now look more closely at the case of Citic Pacific from a corporate govern-ance perspective. Once we go a little be-yond the company’s proclamation in its an-nual report and website that it uphold high standards of corporate governance – which must now be one of the most widely abused and misleading statements in an-nual reports and websites of many compa-nies – it is easy to see that the company has poor governance. This is not the behav-iour of hindsight. One does not even need glasses to see it.

Citic Pacific has a board of 19 directors based on its last published annual report. This may be fine if the board is governing a country. However, it is too wide a power for governing a company. Of these 19 direct-ors, 12 are executives. The chairman is an executive chairman, so even though the company has a managing director, the chairman is the de facto chair-man-cum-CEO. The chairman’s son is also an executive director, and his daughter is a member of the senior management team and holds a finance position. 12 execu-tive directors included the two finance ex-e cutives who executed the foreign ex-change bets and who have now resigned.

Independent directors

Among the seven non-executive directors, four are independent. The Hong Kong list-ing rules require at least three independ-ent directors, so the company meets this require-ment. The Hong Kong Code of Cor-porate Governance recommends at least one-third of the board to be made up of in-dependent directors. Citic Pacific does not meet this recommendation, as independ-ent directors make up less than a quarter. Of the four independent directors, two are brothers (although apparently not related to the chairman’s family). It should be fair-ly evident that the board would not be able to effectively oversee management be-cause the board is essentiallymanage-ment. It is unrealistic to expect internal controls and risk management to be effective in such a company where there is no real check and balance on management.

Let’s now turn to the incentive scheme in the company. There is extensive use of share options. The executive chairman – already a significant shareholder – has 109,000 vested million share options as of Dec 31, 2007. This represents 4.6 per cent of the company’s issued share capi-tal. In total, the 12 executive directors, in-cluding the chairman, have share options totaling almost 3.5 per cent of the issued share capital.

The two executive directors who were responsible for the foreign exchange bets had around four million unexercised opti-ons and about one million shares. They had significant upside exposure, and more lim-ited downside risk at least on the basis of the share increases. Of course, they now have plenty of downside as they have lost their jobs. However, prior to this, they would probably have figured that if the cer-rency bets were correct, the stock price could increase significantly and they could benefit substantially. Share options and de-rivative trading are a dangerous combi-
nation.

Citic Pacific clearly has a low gover-

nance and high risk culture. This is like hav-ing a bomb factory next to a petrochemical plant – and hoping that nobody smokes. Everything mentioned above can be gleaned easily from the annual report. The red flags are all over the place. Perhaps the analysts who were making the bullish recommendations believed that the poor corporate governance can be sustained indefinitely without the company imploding. More likely, they did not look. And inves-
tors who blindly followed recommenda-tions are now paying for it.

I mentioned above that corporate govern-
ance has been going on in this region for at least 10 years. Many directors and sen-
ior executives now have some apprecia-
tion of corporate governance, although im-
plementation of good corporate govern-
ance practices remains patchy.

Throughout this period, it seems that this same awareness has not reached most in the analyst community – at least not when they actually make recommenda-
tions about companies. It almost seems they are living in a parallel universe. It may be time for them to come back down to earth.

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