Blodget's blip: Take a lesson from it

By Mike Tarsala, CBS.MarketWatch.com
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SAN FRANCISCO (CBS.MW) -- Merrill Lynch's Henry Blodget provides the latest reason why investors might want to temper the trust they put in technology analysts.

Internet guru Blodget on Monday cut his ratings on 11 of the 29 shares that he covers. All of the 11 stocks' values were slashed when Blodget put out "buy" recommendations on many of them. The names of the losing stocks include Barnesandnoble.com (BNBN: news, msgs), Buy.com (BUYX: news, msgs), Etoys (ETYS: news, msgs), Pets.com (IPET: news, msgs), Webvan (WBVN: news, msgs) and IVillage.com.

To the surprise of few investors who believe in technical analysis, shares of almost every one of the 11 stocks plummeted after Blodget's recommendations.

Now, his rating cuts are way too little, way too late to stem investors' losses. The value of his basket of picks is down about 60 percent.

Perhaps it's not fair to single out Blodget for making bad predictions. After all, Blodget's certainly not alone. Other Internet analysts also have made horrible choices in recent months.

"The New York analysts are coming out and downgrading the .coms after they've already crashed," said J. Michael Pinson, founder of independent Florida-based analysis firm MarketMavens.com. "It's a little late, and it should be embarrassing for analysts to downgrade stocks after they've plummeted 50 percent to 80 percent in value."

In downgrading his ratings this week, Blodget accomplished little, if nothing for investors. The ratings cut seems to be a face-saving exercise.

Blodget could argue that he didn't really downgrade the stocks at all. The carefully-couched language in his report said that he's simply "resetting the investment ratings."

"Basically the way we structured our ratings is to provide a relative level of enthusiasm for each company," Blodget said in a CBS.MarketWatch.com interview. "This was not a sell call to get out. This was an acknowledgment that the market has changed."

To be sure, Blodget is still recognized as a reputable professional.

Despite the opinions of investors who have lost money through Merrill and other firms, all analysts aren't evil. They can be important go-betweens for investors and a company's management.

That said, there are times when individual investors need to think for themselves -- independent of Henry Blodget and every other guru. To that effect, it's important that investors never forget three
key rules about institutional analysts, and the way the stock ratings game is played:

**Rule 1: Ratings alone mean nothing**

Remember that ratings such as "strong buy," "buy," and "accumulate" don't mean a thing without accompanying research. Investors who dug a little deeper into many of Blodget's stocks would have learned that many had been trading below their 200-day moving averages shortly after Blodget recommended them.

And even investors who stuck with Blodget should have learned from reading his reports that his outlook soured on many of the companies long ago -- even though his official rating didn't change.

Ratings can help to guide investment decisions, says Alan Davis, senior equity analyst at Redchip.com. But investors need to know the fundamental reasons for analysts' ratings. Without the fundamentals, it's best to throw out the rating altogether, he says.

**Rule 2: Follow the dollar**

This rule's the most cynical, but never forget that large institutional firms make money as investment bankers. They may have little incentive to publicly bash an upstart technology stock they're selling, especially when they want to get in good with analysts to get a piece of a start-up's next stock offering.

To the same effect, analysts need to retain relationships with company executives. It's one reason pundits may be encouraged to play softball with ratings. Most investors know this, but a "buy" rating on a new tech stock could mean to "pass it by." And on more established stocks, "hold" often means "sell."

"Academic research has shown that in many cases, analysts elect not to say anything, rather than say something unfavorable," said Ruven Lehavy, accounting professor at the University of California at Berkeley's Haas School of Business. "If they think a company is a sell, they'll stop coverage, or they'll say nothing. So if you don't see anything, sometimes you can infer that it's bad news."

Over the last 10 years, only about 7 percent of all stock recommendations by analysts recommend selling shares, according to Lehavy's research.

**Rule 3: Beware of price targets**

Whether there's any worth to the 12-month price targets analysts set on stocks is up for debate, according to Lehavy. So far, research seems to back up one key fact: A stock with a "buy" rating and a high price target will rise faster than a stock with a "buy" rating and a lower price target, he says.

What's still under study is whether analysts are chasing stock values with their target prices, or if it's the other way around, and analysts simply move stocks with their targets. It's something that Lehavy is studying, along with Alon Brav, finance professor at Duke University.

Maybe to the chagrin of analysts, the professors expect to report results of their research in October.

One of the price targets Lehavy and Brav are looking carefully at is the late 1998 call by Blodget on Amazon.com. The company's shares made a run past what was then the $400 mark in early 1999, after Blodget, then at CIBC World Markets, set a sky-high price target on Amazon shares.

Blodget has kept a "buy" or a "strong buy" rating on Amazon.com's shares for much of the past two years. That's in spite of Amazon's stock spiral of more than 70 percent from a peak in December 1999.
He now has an "accumulate buy" rating on Amazon, for what it's worth. 

Mike Tarsala is a reporter for CBS.MarketWatch.com