

# Can research committees add value for investors? An analysis of Lehman Brothers' Ten Uncommon Values<sup>®</sup> recommendations<sup>1</sup>

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## Abstract

Since 1949 Lehman Brothers has used an investment committee to select the top ten recommendations made by its analysts each year. We examine the performance of this committee's recommendations and find that on average its selections generated abnormal returns of 2.7% at the recommendation announcement and 4.5% for the remainder of the year. This performance cannot be explained by changes in analyst recommendations and/or target prices that accompany the committee report. Nor was it due to analyst screening ability since the returns were higher than those earned from investing in analysts' top stock picks that were not selected by the committee. Finally, we find that abnormal announcement returns and abnormal trading volume at the report publication are correlated with market-adjusted returns for the prior year's stock selections, suggesting that investors believe that a successful process in one year is likely to be repeated the following year. We believe that these findings are particularly interesting given recent efforts to require firms to use research recommendation committees to improve the quality of research.

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for providing us with an overview of how their investment committee works, and for permitting us to identify the company's name in relation to the analyst's recommendations, earnings forecasts, and target prices collected from I/B/E/S and Thomson Financial.

## Can research committees add value for investors? An analysis of Lehman Brothers' Ten Uncommon Values® recommendations

Recent evidence of compromised Wall Street research has raised questions about how to effectively manage and oversee equity research. This study examines one company's longstanding effort to improve the quality and value of its research.

Since 1949, the company in question, Lehman Brothers, has created a research committee to judge the quality of its own analysts' best research ideas and to publish the ten highest-rated ideas in a report titled "Ten Uncommon Values®." Once each year, Lehman analysts are required to present their best research ideas to a committee that typically includes the firm's research directors, investment strategists, and the heads of sales and portfolio management. The committee members review the analysts' top recommendations and select their ten favorites, which are published in the Ten Uncommon Values® report in early July. Interviews with management and analysts indicate that both take the process seriously and that it takes a significant commitment of management and analyst time.

Interest in the value of research committees has been heightened by the Global Settlement requirement that large investment banks create oversight research committees to improve the integrity of their analysts' research<sup>2</sup>. However, there has been remarkably little research on whether such a process improves research quality. The longevity and stability of the committee process at Lehman suggests that top managers at the firm regard it as useful. In our interviews at the firm, managers and analysts explained that the committee adds value to investors by providing oversight and review of the quality and integrity of analysts' research. It also provides valuable mentoring to the firm's analysts on how to improve the quality of their work and enables its managers to identify, first hand, up-and-coming young analysts. Lehman data tracking the performance of its annual selections shows that the committee recommendations have frequently outperformed the S&P 500 Index. However, this evidence alone is insufficient to judge the merits of the process. Prior research indicates that analysts' buy and strong buy recommendations typically outperform the market [Barber et al. (2001)]. Also, the process at Lehman requires analysts to select their top stock pick to present to the committee. It is, therefore, possible that the real value in the process lies in the initial screening by analysts rather than committee overview.

To better assess the value of the process at Lehman, we examine the performance of the ten stocks recommended each year. We find that mean abnormal returns for recommended stocks at the publication of "Ten Uncommon Values®" were 2.6%. These announcement returns were 2-3% higher than those for regular recommendation upgrades and/or target price increases. They were also superior to announcement returns for Lehman analysts' top stock picks that were not screened by the investment committee, suggesting that investors perceive that the investment committee process itself adds value. After the announcement of Ten Uncommon

Values® recommendations, the selected stocks continue to perform well, generating economically and statistically significant abnormal returns of 4.5% for the remainder of the year (days +2 to +250). Similar levels of superior long-term performance (4.4% to 6%) were observed after controlling for returns generated by Lehman strong buy recommendations and its analysts' top recommendations not selected by the committee. Although these differences in performance were economically meaningful, they were not statistically reliable, perhaps because of the smaller sample sizes used.

We then explore whether the performance of the committee's stock selections benefited Lehman by increasing trading volume in the recommended stocks. Abnormal trading volume for the recommended stocks increased by 94% on the date of the report publication and 31%, on average, the following ten days (both relative to the pre-announcement period volume). Presumably, the bulk of this increase in trading volume was channeled through Lehman, enabling the firm to directly benefit from the recommendations through higher commission revenues. Further, abnormal trading volume in the recommended stocks was higher when the prior year's recommendations performed well, suggesting that the potential benefits to Lehman depend on investors' perception of the quality of the committee's analysis. These findings suggest that the research committee process has added considerable value both for investors and the firm using the process. Our interviews with managers and analysts indicate that the process has worked effectively at Lehman in large part because it is taken seriously by top management and the firm's financial analysts<sup>3</sup>. This appears to have been facilitated by the committee review being an annual rather than a continuous process. Top management's time commitment would surely diminish if the process was followed each day, and analysts would probably begin to see the process as bureaucratic. Of course, these are the very conditions imposed on banks by the Global Settlement, raising questions about whether a potentially valuable voluntary initiative is likely to be as useful when it is regulated for all.

### Lehman Brothers Ten Uncommon Values®

Lehman Brothers began publishing an annual list of highly rated stocks in 1949. The process used to select companies for this listing was remarkably consistent throughout the 57 years of its publication. At the end of April each year the Equity Research Department requested that senior equity research analysts (a total of 80 analysts in 2006) complete a standard template on their best fundamental investment idea for the coming year. Each analyst's recommendation was then reviewed by the firm's Investment Policy Committee (IPC) to select the ten best investment recommendations. Towards the end of May, the IPC met with analysts and screened each idea with an eye to investing for a one-year horizon. "From this group of stocks, the members of the Committee analyzed and debated the underlying fundamentals of each company and its industry, each company's competitive position, and the

2 Changes in state pension fund requirements subsequent to the Global Settlement effectively expanded the research committee requirement to cover most brokerage firms, not merely the ten banks directly affected by the Settlement.

3 Behavioral research suggests that, since the dominant culture and reward system at investment banks is to recognize and reward individual accomplishment rather than teamwork, support from top management for the investment committee is likely to be critical to its effectiveness [Hackman (2002)].

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potential catalysts that might lead to superior stock price appreciation in the coming year. The Committee also employed macroeconomic trends and technical analysis as part of this stock selection process." [Lehman Brothers, Ten Uncommon Values (2006)]. After considering market changes that occurred during the time period, a vote was taken to identify the top ten picks that made up the Ten Uncommon Values® portfolio.

The practice was highly publicized within the bank, and interviews with research directors and analysts indicate that both the research committee members and the firm's analysts took the process seriously. The composition of the IPC typically drew on the firm's research directors and the heads of trading and portfolio management. For example, in 2006, the committee comprised seven members, including the firm's Chief U.S. Strategist and Associate Director of U.S. Equity Research, Director of U.S. Equity Research, Associate Director of U.S. Equity Research, U.S. Small-Cap Strategist, Chief Technical Analyst, Head of U.S. Convertible Research, and the Senior Product Manager. The company estimated that collectively the committee had more than 100 years of experience in the investment business.

## Sample and tests

### Sample and abnormal returns

To estimate the performance of Ten Uncommon Values stock recommendations, we collect return data for stocks covered in the report and for several benchmark portfolios. Daily return data is available on the CRSP Daily Stock Return database for at most 409 of the 420 stocks recommended during the period 1963 to 2004<sup>4</sup>. We used two return metrics to measure abnormal return performance at the report announcement. The first, also used by Lehman to judge the effectiveness of the committee recommendations, was the average market-adjusted return for days t-1 to t+1, relative to the report announcement date (t), using the value-weighted CRSP NYSE/NASDAQ index. The second was average cumulative returns for the recommended stocks, again for days t-1 to t+1, minus the average cumulated returns generated for a matched portfolio of stocks with a comparable market capitalization and book-to-market ratio at the end of the Ten Uncommon Values® publication month<sup>5</sup>. The average market capitalization and book-to-market ratio for recommended stocks was U.S.\$10,233 billion and 0.67 respectively. A control stock was selected by first identifying all stocks that had a market capitalization between 70 percent and 130 percent of the recommended stock's capitalization at the end of the Ten Uncommon Values® publication month. From these stocks, we selected the control as the stock whose book-to-market ratio was closest to that of the recommended stock. Finally, we required at least one year of return data surrounding the Ten Uncommon Values® publication day to be available for both recommended and control stocks. The sample with available control matches comprises at most 386 stocks.

To estimate long-window returns for the recommended stocks we use the calendar-time approach suggested by Kothari and Warner (1997), Barber and Lyon (1997), and Mitchell and Stafford (2000). Under this approach, calendar-time returns are estimated by constructing daily portfolio returns from investing in the recommended stocks during the sample period. These portfolios returns are then regressed on risk factors using the following four-factor model:  $R_{pt} - R_{ft} = \alpha_p + \beta_p(R_{mt} - R_{ft}) + s_pSMB_t + h_pHML_t + m_pPMOM_t + \varepsilon_{pt}$ , where  $R_m$  is the return on the value-weighted market CRSP NYSE/NASDAQ index,  $R_f$  is the riskless return, SMB is the return difference for small-cap and large-cap stocks, HML is the return difference for portfolios of stocks with high and low book-to-market ratios, and PMOM is the return difference for stocks with the highest and lowest pre-event period returns (for months -2 to -12).  $\alpha_p$  represents the average daily abnormal portfolio return (Jensen's alpha), and  $\beta_p$ ,  $s_p$ ,  $h_p$ , and  $m_p$  are risk parameters.

### Benchmark portfolios

Prior research indicates that there is a positive market reaction to announcements of analyst recommendation upgrades and to increases in target prices. For example, Barber et al. (2001) found that stocks upgraded from a buy to strong buy in the period 1985 to 1996 earned a 1.06% abnormal return during the three-day announcement period. Stocks that were unrated and which received a first rating of strong buy had a 0.64% abnormal announcement return. In contrast, stocks with no change in rating showed little change in price. Asquith et al. (2005) and Brav and Lehavy (2003) found a significant market reaction to the information contained in analysts' target prices. This suggests that it is important to benchmark returns for the Ten Uncommon Values® stocks against returns for stocks with similar changes in analyst recommendations and target price forecasts. To provide such a benchmark, we used First Call data, available from 1997 to 2004, to identify changes in recommendations and target prices for stocks included in Ten Uncommon Values®. Of the 80 stocks recommended in Ten Uncommon Values® during this period, 28 (35%) had an increase in target price and/or an upgrade to strong buy at the time of the publication of the Ten Uncommon Values® report<sup>6</sup>. The remaining 52 stocks (65%) received continued strong buy recommendations and had no change in target price forecasts at the publication of Ten Uncommon Values.

Using the First Call database, we created a benchmark portfolio of firms that had comparable recommendation and target price behavior as the stocks included in Ten Uncommon Values. Of the set of all strong buy recommendations by Lehman analysts that were not in Ten Uncommon Values (a total of 2,313 stocks), 1,248 (54%) had a change in recommendation and/or target price at the recommendation date. These firms were used as a benchmark sample for Ten Uncommon Value stocks with recommendation upgrades and/or increases in target prices. The remaining 1,065 stocks (46%) had no changes in recommendation or target price

4 Daily returns are not available in a machine-readable form prior to 1963. We examined monthly returns for 515 of the 540 stocks recommended since 1949. The results were very similar to those reported in the paper.

5 Our approach follows that of Barber and Lyon (1997) and Lyon et al. (1999).

6 Of these, 20 had an increase in target price but no change in recommendation, four had a recommendation upgrade but no change in target price, and nine showed a change in both.

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and were used to benchmark returns for Ten Uncommon Values stocks that also had no change.

Of course, the stocks selected for Ten Uncommon Values are not typical strong buy recommendations; they are selected from a list of analysts' best investment ideas. If analysts themselves do a good job of screening the recommendations that they present to the committee, any random selection from that set of recommendations will tend to outperform non-reviewed recommendations. We, therefore, compare the Ten Uncommon Values® selections to top investment recommendations made by analysts at the time of the committee's deliberations. We anticipate that these selections will closely correspond to the recommendations that the committee reviews each year, effectively controlling for any selection ability of the analysts.

To select the top stock picks for each analyst, we first identified all stocks that were rated as strong buys between January and July each year, the period during which analysts identified their top picks for the Ten Uncommon Values®, and which had target price data available<sup>7</sup>. If a target price was not announced on the same day as the recommendation date, we used the closest price forecast announced in the period thirty days prior and five days after the recommendation date<sup>8</sup>. If an analyst did not make any strong buy ratings during this period, we identified all their buy recommendations with available target prices<sup>9</sup>.

The next step in our selection process was to rank the top stock recommendations for each analyst and year by forecasted stock appreciation, measured by the target price deflated by the actual price on the price forecast date<sup>10</sup>. We excluded all recommendations of stocks included in the Ten Uncommon Values® recommendations during that year. We also eliminated recommendations with predicted price appreciation rates higher than 1000%, since these appeared to be data errors. The analyst's top pick in a given year was the stock that had the highest expected price appreciation. The sample comprised 263 analyst top picks (183 Strong Buy and 80 Buy recommendations)<sup>11</sup>.

## Performance of Ten Uncommon Value stocks

### Abnormal returns for recommended stocks

Figure 1 reports abnormal returns at the publication of the report, and for the pre- and post-publication periods. At the publication of the report, the recommended stocks increased in value by 2.7% (using market-adjusted returns) and 2.6% (using size and B/M controls), both highly statistically significant. After the announcement, the stocks continue to perform well, generating statistically significant annualized abnormal returns of 4.5%. The total return from

Panel A - Announcement returns for days t-1 to t+1	
	Mean return
Market-adjusted returns	2.7% <sup>a</sup> (n=409)
Abnormal returns adjusted for size and B/M factors	2.6% <sup>a</sup> (n=386)
Panel B - Pre- and post-announcement returns	
	Mean return
<b>Pre-announcement returns (for days t-250 to t-2)</b>	
Annualized calendar method abnormal returns	18.8% <sup>a</sup> (n=360)
<b>Post-announcement returns for days t+2 to t+250</b>	
Annualized calendar method abnormal returns	4.5% <sup>b</sup> (n=367)
a, b, and c denote significance at 1%, 5%, and 10% levels using a two-tailed test	

Figure 1 - Mean abnormal returns for Lehman Brothers' Ten Uncommon Values® stock recommendations

investing in the recommended stocks, including the announcement effect, was therefore roughly 7%, which is economically material.

It is also interesting that the recommended stocks showed strong positive abnormal performance in the 250 days prior to the report publication. Average abnormal returns during this period were 18.8%. There are several potential explanations for this pattern. One is that the committee and/or analysts recommended stocks that had shown strong recent performance, rather than stocks that were out of favor. Another possibility is that the committee selected stocks that analysts had recommended to their clients prior to the publication of Ten Uncommon Values®, and that at least some of the run up reflected market reactions to earlier analyst reports.

### Comparison with other benchmarks

The positive abnormal returns earned by stocks recommended in the Ten Uncommon Values® are consistent with the investment committee selecting stocks that are good investments for investors. However, it is also possible that these returns were attributable to the performance of the analysts who recommend the stocks to the committee, rather than the committee per se. All of the Ten Uncommon Values® recommendations were strong buys, some with upgrades in recommendation and increased target price forecasts, indicating that the analysts that recommended these stocks in the first place were optimistic about their prospects. To calibrate whether and how much of the performance of the stocks recommended in the Ten Uncommon Values® reflected information conveyed by the analyst recommendations rather than the investment committee screening, we compared the stock performance for the Ten Uncommon Values® recommendations to that of comparable strong buys recommendations by Lehman analysts.

7 To test the sensitivity of the January to July window, we also ran the tests using the period January to June, April to July, and April to June. The results are similar to those reported in the paper.

8 There appear to be differences in the announcement dates for some of the target prices and stock recommendations reported by First Call's two databases. We adopted the above procedure to match target prices and stock recommendations.

9 Twenty-five analyst-year observations include only hold and sell recommendations during this period. We excluded these from the tests since the committee would obviously not consider these analysts' recommendations seriously.

10 To identify the best stock pick for each analyst, we needed to identify individual analysts. Yet First Call, our source of target price and recommendation data, did not provide information on analyst identities. We therefore used Thompson Financial earnings forecast database, which does include analyst identity, to detect the names of analysts who made earnings forecasts within sixty days of strong buy recommendations.

11 We also reran the tests using only strong buy recommendations. The results are similar to those reported in the paper.

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Return methodology	Mean market-adjusted returns	Mean returns-adjusted for size and B/M factors
<b>Panel A - Stocks with recommendation upgrades and/or increased target price forecasts</b>		
Ten Uncommon Values®	5.0% <sup>a</sup> (n=28)	5.4% <sup>a</sup> (n=27)
Comparable Lehman strong buys	2.8% <sup>a</sup> (n=1,248)	2.6% <sup>a</sup> (n=1,232)
Difference	2.2% <sup>b</sup>	2.8% <sup>b</sup>
<b>Panel B - Stocks with no recommendation upgrades and/or increased target price forecasts</b>		
Ten Uncommon Values®	2.6% <sup>a</sup> (n=52)	3.0% <sup>a</sup> (n=52)
Comparable Lehman strong buys	0.4% <sup>b</sup> (n=1,065)	0.3% (n=1,046)
Difference	2.2% <sup>a</sup>	2.8% <sup>a</sup>
<b>Panel C - Ten Uncommon Values versus top rated strong buy/buy recommendations not included in Ten Uncommon Values</b>		
Ten Uncommon Values®	3.4% <sup>a</sup> (n=80)	3.8% <sup>a</sup> (n=79)
Comparable Lehman strong buys	1.8% <sup>a</sup> (n=422)	1.9% <sup>a</sup> (n=416)
Difference	1.6% <sup>b</sup>	2.0% <sup>b</sup>

a, b, and c denote significance at 1%, 5%, and 10% levels using a two-tailed test

Figure 2 - Differences in abnormal announcement returns (days t-1 to t+1) for Lehman Brothers Ten Uncommon Values® stock recommendations and comparable Lehman Brother's recommendations not included in Ten Uncommon Values®

Panel A of Figure 2 reports the average publication announcement returns for the Ten Uncommon Values® stocks and for other strong buy stocks that received a simultaneous recommendation upgrade and/or a target price increase in the period 1997 to 2004. The mean abnormal announcement return for stocks recommended in Ten Uncommon Values® was 5.0% using market-adjusted returns and 5.4% using matched size and B/M controls, both significant at the 1% level. Comparable abnormal returns for other stocks that Lehman analysts upgraded to strong buy and/or increased their target price forecasts were 2.8% and 2.6%, and were also significant. However, the difference in returns (2.2% and 2.8% depending on the normal return benchmark) was statistically significant, indicating that investors perceived the Ten Uncommon Values® recommendations to be more valuable than other stock upgrades/target price increases.

We also estimated the abnormal returns for Ten Uncommon Values® stocks that were not upgraded and had no target price increases at the publication date during the period 1997 to 2004. For these stocks, the mean market-adjusted and size/BM adjusted returns were 2.6% and 3.0% respectively, both significant at the 1% level. In contrast, there were no economically significant abnormal returns at the publication of analyst reports that simply reiterated prior strong buy recommendations and target prices. The difference in returns between these portfolios was 2.2% and 2.8% respectively, both statistically significant.

	Period relative to Ten Uncommon Values announcement date (t)	
	t-250 to t-2	t+2 to t+250
<b>Panel A - Stocks with recommendation upgrades and/or increased target price forecasts</b>		
Ten Uncommon Values®	55.9% <sup>a</sup>	15.6%
Comparable Lehman recommendations	20.4% <sup>a</sup>	4.1%
Difference	26.6% <sup>a</sup>	5.7%
<b>Panel B - Stocks with no recommendation upgrades and/or increased target price forecasts</b>		
Ten Uncommon Values®	22.8% <sup>a</sup>	6.1%
Comparable Lehman recommendations	16.4% <sup>a</sup>	-0.7%
Difference	8.8%	4.4%
<b>Panel C - Top rated strong buy/buy recommendations not included in Ten Uncommon Values</b>		
Ten Uncommon Values®	34.4% <sup>a</sup>	8.6%
Comparable Lehman Strong Buys	11.6% <sup>a</sup>	-2.1%
Difference	22.1% <sup>a</sup>	6.0%

a, b, and c denote significance at 1%, 5%, and 10% levels using a two-tailed test

Figure 3 - Mean abnormal pre- and post-announcement returns for Lehman Brothers' Ten Uncommon Values® stock recommendations.

Finally, we compare the announcement returns for Ten Uncommon Values® stock recommendations and Lehman analysts' other top stock picks. These tests are designed to assess whether investors value the recommendations because of the committee screening process or because analysts themselves screened the stocks they identified as candidates for review by the committee. The findings in panel C of Figure 2 indicate that the abnormal announcement returns for the Ten Uncommon Values® recommendations exceeded those for other Lehman analyst top stock picks by 1.6% (using market-adjusted returns) and 2.0% (using size- and B/M-adjusted returns). These differences were significant at the 5% level.

To examine whether these findings also hold for longer holding periods surrounding the publication, we replicate the tests using calendar method abnormal returns for days t-250 to t-2 and for days t+2 to t+250 relative to the report publication. The findings, reported in Figure 3, show that in the post-publication period Ten Uncommon Values® recommendations generated mean abnormal returns of 15.6% for stocks accompanied by recommendation upgrades and/or target price increases and 6.1% for stocks with no such changes. These estimates exceeded mean abnormal returns for comparable non-Ten Uncommon Values® Lehman recommendations by 5.7% and 4.4% respectively. Finally, long window abnormal returns for Ten Uncommon Values® recommendations exceeded those of Lehman analysts' other top stock picks by 6.0%. While these estimates are economically significant, they are not statistically reliable, perhaps because the power of the tests is relatively low for measuring long-window stock performance since we have only eight years of data.

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Prior to publication of Ten Uncommon Values® the recommended stocks typically outperform the benchmark portfolios. The mean abnormal returns for stocks with and without concurrent recommendation/target price changes are 55.9% and 22.8% respectively, both statistically significant. These estimates exceed the benchmark returns by 26.6% (significant at the 1% level) and 8.8% (insignificant). Overall Ten Uncommon Values® stocks generated mean abnormal returns of 34.4% prior to publication, 22.1% greater than the performance of Lehman analysts' other top stock picks. Both estimates are highly statistically significant.

Overall, the results indicate that the stocks selected for Ten Uncommon Values® generate strong returns prior to the publication of the committee report, perhaps because analysts and/or the committee favored strong-performing stocks, or analysts first recommended the stock prior to the publication of Ten Uncommon Values®. However, the report itself conveys additional information to investors. Recommended stocks increase in value by 2-3% beyond that generated by comparable ratings and target price changes or by analysts' recommendations of top stock picks. There is some evidence of continued superior performance after publication, but this effect, while potentially economically significant, is too noisy to draw strong statistical inferences upon.

## Impact of Ten Uncommon Values on trading volume

In follow-up tests, we examine whether the Ten Uncommon Values report is accompanied by increased trading volume for the stocks recommended. Daily trading volume data for stocks included in Ten Uncommon Values is available from 1963 to 2004 on CRSP. For each stock, an index of daily abnormal trading volume is estimated



Figure 4 - Average normalized daily trading volume for Lehman Brothers' Ten Uncommon Values® stock recommendations for ten trading days surrounding the publication date

Independent variables	Coefficients (t statistics) Dependent variable	
	Mean announcement date abnormal stock returns	Mean announcement date abnormal trading volume
Constant	0.02 (4.3) <sup>a</sup>	1.11 (8.0) <sup>a</sup>
Mean market-adjusted returns for prior year's Ten Uncommon Values recommendations	0.08 (3.7) <sup>a</sup>	4.71 (6.5) <sup>a</sup>
Adjusted R <sup>2</sup>	0.24	0.51

a, b, and c denote significance at 1%, 5%, and 10% levels using a two-tailed test

Figure 5 - Relation between abnormal trading volume and returns at the announcement of Ten Uncommon Values® stocks, and annual abnormal returns from investing in the prior year's Ten Uncommon Values® recommendations

by deflating trading volume by the mean daily volume in the pre-announcement period (event day t-20 to t-11).

Figure 4 shows mean abnormal trading volumes for 409 stocks (daily return data is available on the CRSP Daily Stock Return database for 409 of the 420 stocks recommended since 1963) with available data from twenty days before to twenty days after the report publication. Abnormal daily volume increased by 94% on the report publication day. On average, over the next ten days, daily abnormal trading volume was roughly 31% higher than in the pre-publication period. It is unclear how much of this increase in volume is channeled through Lehman Brothers, but it seems reasonable to expect that Lehman receives a disproportionate share.

Finally, we examine how investors revalue recommended stocks at the publication of Ten Uncommon Values®. One reasonable approach is for investors to infer the value of the recommendations from the performance of last year's picks. To evaluate whether investors use this approach, we estimate the relationship between abnormal stock returns and abnormal trading volume at the report publication, and annual market-adjusted returns for prior year selections, the metric used by Lehman to advertise the performance of its selections. The estimated relations are reported in Figure 5.

The relation between abnormal returns at the announcement of the Ten Uncommon Values® report and market-adjusted returns from last year's stock recommendations is positive and highly statistically reliable. The estimate of 0.08 implies that if last year's recommended stocks earned a mean abnormal return of 10%, investors revalued the price of the current year's recommendations by 0.8% immediately the report is published.

The relationship between abnormal trading volume at the report publication and the performance of last year's stock selections is also positive and significant, implying that investors purchase more stock in the current year's recommendations if the prior

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years' selections were profitable. The estimated coefficient of 4.7 implies that if last year's recommended stocks earned a mean abnormal return of 10%, abnormal trading volume would be 47% higher than typical abnormal trading volume for newly recommended stocks.

### Conclusion

Our tests indicate that investors perceive that Lehman Brothers' use of a research committee to screen analysts' selections for the Ten Uncommon Values® adds value to their analysts' recommendations. Stocks recommended in the reports published from 1963 to 2004 increased immediately by an average of 2-3%. This performance cannot be explained by changes in analyst recommendations and/or target prices that accompany the committee report. Nor can it be explained by analyst screening ability, since the returns were higher than those that could be earned from buying and holding analysts' top stock picks that were not selected by the committee.

For the year following the report's publication, the recommended stocks continue to appreciate by roughly 4.5%. This subsequent appreciation is both statistically and economically significant. However, data from 1997 to 2004 (when stock recommendations and target prices are available) indicate that although the mean level of this post-announcement appreciation persists after controlling for returns to other comparable recommendations or top stock picks by Lehman analysts, the differences become statistically unreliable, perhaps because of a decline in the power of our tests.

The report publication is also accompanied by a 94% increase in abnormal trading volume for recommended stocks at the report release date, and by a 31% increase for the next ten days, implying that if Lehman captures a disproportionate share of this increased volume there are direct private benefits to the firm that offset the cost of management and analyst time committed to the process. Finally, abnormal announcement returns and abnormal trading volume at the report publication are correlated with market-adjusted returns for the prior year's stock selections, suggesting that investors believe that a successful process in one year is likely to be repeated the following year.

We believe that these findings are particularly interesting given the recent requirement that firms use research committees to improve the quality of research. Lehman's Ten Uncommon Values process is very similar to that used by some of the large banks following the Global Settlement. For example, at one leading firm analysts are required to submit a request for committee approval of proposals to change a stock recommendation or to cover new stocks one hour before specified daily times when the committee meets. Emergency meetings are also allowed. The committee requests analysts to prepare a short written statement and to present their views on a company, its management, outlook, positives and risks,

and valuation in person. Analysts are expected to convince the committee that their ideas are logical and well argued, based on sound modeling and analysis. At this firm, members of the research recommendation committee usually include the department's big guns – the research director and the investment strategist – as well as salesmen and compliance officers.

Not surprisingly, opinions on the success of the research recommendation committees varied across firms and analysts. At firms where management took the mandate seriously, many analysts commented that the process had improved the quality of their work. The committee aggressively critiqued their analysis and could send their reports back to the drawing board. One ranked analyst commented "meeting with the investment committee was more than just defending stock picks. I can't say that I have ever learned more at any place or time on how to do my job as an analyst than during these meetings<sup>12</sup>." However, a more common perception is that the process is yet another regulatory burden, leading to a check the box mentality by both analysts and the committee itself. As one analyst we interviewed pointed out, "how can a number of people who rarely agree on anything outside this room actually agree on something that they know little about? They are not experts in my sector<sup>13</sup>." Concerns were raised that the process required too much time and preparation, especially in cases where it was obvious that the committee would approve the changes.

The experiences of Lehman in its Ten Uncommon Values potentially help us to understand the conflicting views among managers and analysts on research recommendation committees. The success and longevity of Lehman's approach owes much to the commitment of its top management and analysts. This is facilitated by the firm's decision to run the process only once a year. It is easier to generate enthusiasm and commitment for an annual process than an ongoing one. Special recognition can be provided to analysts whose ideas are validated by the committee. Top managers find it easier to commit the time to an annual event than to an ongoing process. Indeed, top managers on the Lehman committee commented that in many years they worked until early mornings to review and debate the merits of analysts' ideas.

In contrast, the Global Settlement requires firms to use research recommendation committees continuously. This mandate may provide early benefits to firms whose managers and analysts are committed to the process. However, once it has been successfully implemented, we anticipate that top managers are likely to devote their energy to the next challenge, leading to analysts becoming increasingly skeptical of the process, as we observed at many firms. This might lower the perceived benefits of committee oversight and support for the process. This would be a pity, since Lehman's experience suggests that a firm-initiated process that is used sparingly and with top management support can help to improve research quality.

<sup>12</sup> Quote from an analyst at a leading investment bank, based on our field research.

<sup>13</sup> Source: Field research interview with financial analyst at a leading investment bank.

# Can research committees add value for investors? An analysis of Lehman Brothers' Ten Uncommon Values® recommendations

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