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CFA SINGAPORE INSIGHTS

By Frank Li and Chan Fook Leong

Independence and objectivity

Beyond a point, "benefits" offered to analysts amount to bribes

THE Hong Kong street protests are entering their sixth month. Although the extradition Bill was formally withdrawn on Sept 4, thousands of protestors are still taking to the streets. The ongoing protests have had consequences on many facets of daily life and business in the Chinese territory.

Naturally, investment analysts need to factor these developments into their forecasts. For one analyst, however, doing so was an uphill battle.

Zhao Dongchen, head of equity research at state-owned Industrial & Commercial Bank of China, issued a strong "sell" call on Cathay Pacific Airways Ltd. (At the time, Bloomberg noted 13 buy calls and five hold calls on Cathay.)

Following the call he made, he was reported by Bloomberg last month as having said: "Never before in my 36 years of life have I been under such heavy pressure (from a lot of people)."

The Hong Kong-based Cathay Pacific airline had come under fire from Beijing after some of its employees took part in the street protests that have rocked Hong Kong to its core; the full-service carrier found itself the target of boycott calls from Chinese government agencies.

Mr Zhao is standing by his "sell" call on the airline's stock. He has reiterated that his research and views are independent.

Security analysts and capital market anomalies

A recently published joint research paper by Li Guo and Frank Li from Singapore Management University, together with John Wei from Hong Kong Polytechnic University, delved into potentially systematically biased analysts' recommendations.

The paper, on security analysts and capital market anomalies, compared analysts' consensus recommendations to an objective valuation metric on the same stock, and found that in most cases, analysts' recommendations contradicted the valuation metric.

Analysts tend to give a positive opinion on stocks that are overvalued (hence, according to the objective metric, they should be sold), and a negative opinion on stocks that are undervalued (hence, according to the objective metric, they should be bought).

The paper laid out several possible reasons for analysts' widespread bias. One finding suggested the bias could be driven by analysts' incentive to curry favour with managers of firms that can potentially be investment-banking clients.

Other reasons include firms needing to raise large amounts of debt or equity in near future, which could do with favourable ratings from sell-side analysts.

The researchers also found that not all analysts are equally susceptible to this type of conflicts of interests. Some are objective, in that they align their recommendations to the valuation metric. Over time, investors recognise these analysts, whose views are deemed independent, and naturally place more weight on their opinion.

Independence and objectivity standard

External sources may try to influence the investment process by offering analysts and portfolio managers a variety of benefits. Corporations may seek expanded research coverage, issuers and underwriters may wish to promote new securities offerings, brokers may want to increase commission business, and independent rating agencies may be influenced by the company requesting the rating.

Benefits may include gifts, invitations to lavish functions, tickets, favours or job referrals. One type of benefit is the allocation of shares in oversubscribed IPOs to investment managers for their personal accounts.

This practice affords managers the opportunity to make quick profits that may not be available to their clients and is prohibited under this standard.

Modest gifts and entertainment are acceptable, but special care must be taken by CFA members to resist subtle and not-so-subtle pressures to act in conflict with the interests of their clients. Best practice dictates that members reject offers of gifts or entertainment that could threaten their independence and objectivity.

Case study: Just building client relationships?

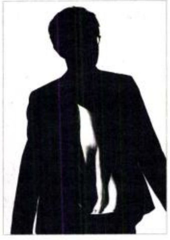
Today's case is based on a US Securities and Exchange Commission enforcement action from 2016. As a guide, the desired ethical behaviour required is based on the CFA Institute Code of Ethics and Standards of Professional Conduct.

Hamzah is a founding partner and CEO of JPA, a large wealth-management firm with offices throughout the world.

The firm has many global institutional clients that include state-owned entities run by government officials. In an effort to build client relationships, he initiates a "Client Internship Programme" that allows clients to refer candidates for internships at JPA.

Referrals from this programme are considered for employment outside of the firm's normal rigorous and competitive hiring process.

The larger the JPA client, the more likely a referral from this client would bag a lucrative, career-building internship position. JPA hires more than 200 relatives and friends of the key executives of many JPA clients, including relatives and friends from many government agencies with which JPA has investment banking or asset management relationships.



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JPA generates more than US$100 billion in revenue from these investments and uses the connections generated with these clients to assist other clients and navigate complicated regulatory landscapes.

Hamzah's actions in establishing the JPA "Client Internship Programme" are:

A: Appropriate because the programme benefits clients.

B: Appropriate because the programme is an incentive for clients that hire JPA, similar to discounted fees.

C: Appropriate because the programme creates a mutually beneficial business relationship between JPA and its clients.

D: A violation of the CFA Institute Code and Standards.

Analysis

This case relates to the CFA Institute Standard of Independence and Objectivity, which states that CFA Institute members "must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise... another's independence and objectivity".

JPA uses the internship opportunity to personally benefit the relatives and friends of certain key individuals, including government officials, with the intent to corruptly influence those decision-making officials and executives. So, response D is the correct choice because this practice is a violation of the Independence and Objectivity Standard.

Modest gifts and entertainment in the ordinary course of business may be acceptable in the context of promoting professional services. Similarly, firms may offer large or significant clients discounts or incentives commensurate with their position.

But this does not extend to offering what amounts to bribes to individual executives or government officials to influence the hiring process or look favourably on investment transactions. In this case, the benefits were not to JPA's investment clients but were personal to the individual decision-makers.

This column is adapted from content by the CFA Institute and reprinted here with permission from the institute.

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