

MERRILL LYNCH: THE GOOD NEWS AND THE QUESTIONABLE NEWS

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There's been good news and questionable news coming out of Merrill Lynch & Co. Inc. in the past few weeks.

The good news: John Thain has done something that is utterly counterintuitive to most chief executive officers: He has actually purchased shares with his own money.

The questionable news: Merrill has instituted a forced rating system for analysts to cut down on all the cheerful "Buys" that seem to be routinely assigned.

The Good News

On July 29, Mr. Thain purchased 500,000 shares of Merrill stock, paying \$22.50 for each share, or \$11.3 million in all.

He got a pretty good deal, as it turns out, because the range of trading prices that day was \$22 to \$26.52, with the stock closing at \$26.25.

Based on the \$26.87 close price on Aug. 8, Mr. Thain has already garnered a paper profit of \$2.2 million.

What Mr. Thain has done brings to mind a favorite strategy of the corporate governance priesthood, namely, that CEOs and other senior officers should own a goodly number of shares or, in the words of Warren Buffett, "eat their own cooking".

Being mostly naïve do-gooders, the corporate governance priesthood thought that CEOs everywhere would pull a Thain, namely, open their own wallets and buy their company's shares. Or, if they couldn't bring themselves to do that, they would at the least hold on to their option shares following exercise (after first paying for the option's strike price and the associated income taxes), as well as their free shares (after selling sufficient shares for tax purposes).

Some CEOs have done the last two things – or at least some of the last two things.

But the favorite strategy of most CEOs is to do none of those things. Rather, they con their boards into souping up the size of their stock option grants and their free share grants so that they can declare to shareholders, with the clearest of consciences, that they are indeed "eating their own cooking". Studies by numerous economists have shown that when you give people all the food they can eat for free, they tend toward gluttony.

So, with that as backdrop, it gladdens the heart to see a brave soul like John Thain upping his shareholdings the old-fashioned way.

The Questionable News

Despite efforts to the contrary, stock analysts are rating too many stocks as “Buys” and not enough as “Holds” or “Sells”.

Merrill’s solution to this problem is to impose a forced distribution on analysts. Its new approach has been published in the form of “dispersion guidelines”.

According to a Bloomberg News story, Merrill will force an “Underperform” rating on any stock the analyst believes will produce a negative total return in the next 12 months (or, alternatively, which is expected to badly underperform its industry). A “Neutral” rating will apply to a stock the return on which is expected to be greater than zero but less than 10 percent. “Buy” ratings will be limited to stocks that look to return more than 10 percent.

One nagging question involves the relativity of stock returns. In many periods, a stock return of 10 percent or more is indicative of above-average performance. But how about a year in which the Dow Jones Industrial Average increases 25 percent or more, as it did in 1995 (36.9 percent), 1996 (28.9 percent) and 1999 (27.2 percent)? And in any event, what analyst is so finely-tuned as to predict that a stock will return precisely 10 percent, thereby leading to an “Underperform” rating, instead of 10.1 percent, which would produce a “Buy” rating.

What Merrill has done sounds like a fine idea. But forced distributions have a way of not working out – or not working out for very long.

Back in 1963, when I first joined the corporate staff of aerospace giant General Dynamics Corp. (the firm was then headquartered in New York City), a new chief human resources officer, who had been brought in from General Motors Corp., was quite distressed to find that virtually every exempt employee was receiving a raise every year.

To remedy this injustice, he invented what he called the “Increase-to-Pass” ratio. What that meant was that only 65 percent of employees could receive an increase in a given year, with 35 percent being “passed”.

I remember one engineering manager telling me: “Look, I have a 10-person workgroup, and I have already fired the incompetents. Everyone left is an outstanding performer. So why should I be forced to pass three of my employees, or maybe it’s four of my employees, since King Solomon already opined that half an employee would not be good for anyone?”

And what about another manager who told me he had a two-person group. “So, what am I supposed to do: Hire a third person so I can pass one of them?”

Of course, most all performance rating systems are heavily biased towards overrating. As one manager told me: “If the Savior returned to earth today, he would be hard-pressed to receive a performance rating equal to that of our average employee.”

Over time, the system at General Dynamics got gamed. Some scientist in that high-tech company figured that the 65%-35% Increase-to-Pass plan could be out-manuevered simply by spreading raises over 18 months. So in Year 1, 65 percent got a raise and 35 percent got passed. Then in Year 2, the passed people from Year 1 got a raise, and half or so of the people who got a raise in Year 1 were passed. The end result: In any eighteen-month period, everyone got a raise.

The statistics flowed into corporate headquarters, and the chief human resources officer was mightily pleased that he had achieved so much progress.

I wish Merrill better luck with its forced analyst ratings, but given the ingenuity of most employees, I figure Merrill’s system will be gamed, too.