

# SmartMoney

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**Precursor**

# Side Effects

SEC strictures on independent research have backfired, hurting investors.

BY ERIC J. SAVITZ

**Not all that long ago, the Washington-based investment research firm called the Precursor Group was one of my most trusted resources for figuring out how things were going in the technology**

business. Precursor specialized in uncovering long-term industry trends. To this day, its analysts' thinking shapes my views on a diverse group of issues, including Internet telephony, the future of the cable industry and the long-term prospects for Microsoft. They shunned price targets and earnings models and the other trappings of the standard Wall Street research firm. And that's what made Precursor such a good resource: Freed of the tyranny of quarterly earnings estimates, they were able to actually sit back and think. And then they'd write concise, fact-packed research notes, generally no more than a single page in length.

Originally part of the Baltimore-based investment firm Legg Mason, the Precursor Group spun out on its own in mid-2000. The company grew steadily and in 2004 seemed perfectly positioned after New York State Attorney General Eliot Spitzer, along with the Securities and Exchange Commission, negotiated the Wall Street global settlement, which called for 10 big, full-service brokerage firms to spend millions to provide their clients with independent sources of investment research.

So here's the sad thing. The Precursor Group disappeared early this year. Scott Cleland, one of the firm's founders, has reconstituted it under a similar name—now it's simply called

Precursor—but with a new mission, to serve the research needs of industry rather than Wall Street. Cleland says he went that route because the independent investment-research firm has become an endangered species.

“The bubble and all of the Wall Street and mutual fund scandals inalterably changed investment research,” Cleland said in an interview with SMARTMONEY. “We had lakefront property. But the lake was polluted with scandal. And now the government is draining the lake. In other words, it has become a lousy business. The SEC's response to the scandals has unintentionally destroyed it.”

Cleland believes the landmark research deal Spitzer cut with the Street is having the opposite effect of what the government intended: Rather than bolstering independent research firms, he believes it is killing them. “The way they chose to punish Wall Street firms, making them give away independent research for free, has devastated the free marketplace for research,” he says. “It set the price for research at zero and subsidized competitors with [money from] five years of SEC penalties.”

Cleland says that new regulatory strictures also worked against Precursor's business model. “The rules have encouraged analysts to be a mile wide and an inch deep,” he says, adding that

## Tech File

the rules have also discouraged research that veered from the standard Wall Street recommendation-and-price-target model. That's bad for investors, he says, who want ideas, insights, understanding of the industry and expert sources rather than banal price targets.

The frustration in Cleland's voice rises as he talks about another pet peeve: the SEC's approach to "soft dollars"—the practice of big institutional investors conducting trading with firms in exchange for free research. The practice of using soft dollars came under scrutiny in the post-bubble years, but it never triggered any rule changes. "The SEC remained shockingly silent for three years," Cleland says, "and the market interpreted that silence as proof that soft dollars were going away." As a result, independent research firms that relied on soft dollars saw business disappear.

Cleland also has a problem with Regulation FD—a 2000 SEC rule that requires public companies to disclose information in such a way that the general public has access to it at the same time as institutional investors and analysts. Cleland calls Reg FD "inherently anti-research," because it promotes the idea that all information should be standardized and homogenized, creating an environment where digging for facts could be a violation of the rules.

In the end, shifting regulatory sands made investment research a crummy business, Cleland says. "Bill Whyman and I started the business in June 2000. We were profitable in all five years we were in business. We were considered the best forward-looking research firm out there in tech and telecom. And we made our clients money. *Institutional Investor* named


us the best independent research firm in 2004 and 2005. The same month we won the 2005 award, we shut down."

Yeesh. So what happened? "There was no growth or opportunity left in the business," Cleland says. Initially, when

Precursor's research made clients money, those clients rewarded them by executing trades through Precursor. But when the game changed from performance-based pay to hard-dollar subscriptions, the pool available for independent research shrank from \$10 billion to \$1 billion, Cleland says.

"With the shift to subscriptions, it became a one-way dynamic," Cleland says. "You pay in advance for research, good or bad. The regulators adopted a managed-competition approach and unintentionally eliminated all the opportunity."

So what would fix the system? "The prescription is obvious," he says. "Let the market work. Stop micromanaging the research industry and regulating it as if it were one homogenized industry."

Cleland conceded that there was one other factor at work—one that may be the most damaging of all for the future of investment research. "Precursor was all about anticipating change. Over the past five years, dramatically fewer investors have focused on the long term. If it's not happening in this calendar year, it might as well be happening on Pluto. That's why I now work for companies. They still care about the future." 

Contributing editor ERIC J. SAVITZ can be reached by e-mail at [eric.savitz@dowjones.com](mailto:eric.savitz@dowjones.com). Read his blog at [blogs.barrons.com/techtraderdaily](http://blogs.barrons.com/techtraderdaily).

**The independent investment-research business has become an endangered species.**