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Wall Street Analysts Tap into Capitol Gains

New Research Shows Analysts May Use Campaign Contributions to Bolster Performance

By JUSTIN LAHART

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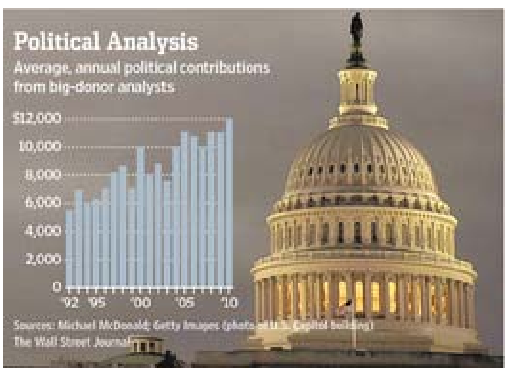
Politics makes strange bedfellows. It can also make Wall Street analysts strangely accurate.

Political intelligence, the business of gathering information about Congress and government and selling it to investors looking for an edge, has been a burgeoning business. It also has been controversial, raising questions among some regulators.



And the reach of political intelligence may be deeper than many realize. New research suggests brokerage analysts who donate heavily to politicians benefit from political access.

The findings add further evidence that the playing field in financial markets has become deeply uneven, with deep-pocketed and connected investors enjoying advantages most individuals can't muster. Amid rapid growth in areas such as political intelligence and high-frequency trading on economic releases, concerns are mounting that more investors will conclude the game is rigged, undermining the trust in financial markets the U.S. economy needs to thrive.

The research on analysts comes from Michael McDonald, a Ph.D. candidate at the University of Tennessee. He gathered data on estimates and recommendations from over 9,000 sell-side analysts from Thomson Reuters' I/B/E/S database, covering 1992 through late 2012. He then matched analysts with data on individual political donations from the Federal Election Commission. Finally, he classified as big-donor analysts those whose contributions fell in the top 5% of all individual donations recorded by the FEC for the U.S. population at large.

Big-donor analysts were much more talented at forecasting company results than peers, according to the research, which was presented earlier this month at an academic conference. Mr. McDonald found their earnings estimates were considerably more accurate than other analysts—especially if they covered industries that are dependent on government spending or are heavily regulated, such as defense and pharmaceuticals.

Tellingly, analysts became more accurate after they made their first political donation, and their precision dropped when they stopped donating. Additionally, those who focused contributions on a single politician or small number of them were more accurate than those who spread them more widely.

Big-donor analysts also had an unusual knack for stock picking, with Mr. McDonald calculating the shares they recommended outperformed recommendations of other analysts by 4.9 percentage points a year, on average. On Wall Street, that kind of outperformance is big, and potentially lucrative.

The findings don't imply legal boundaries were crossed. After all, analysts like anyone else, are allowed to make campaign contributions. And even if those led to increased access, that doesn't necessarily mean anything nefarious occurred. For example, an analyst attending a $1,000-a-plate dinner hosted by a member of a congressional subcommittee on defense might get into an informative conversation with someone in the industry.

Gathering disparate bits of information to create an investing mosaic is generally legal and is part of an analyst's job. It can still raise eyebrows, though. Earlier this month, BlackRock agreed to terminate a survey of analysts used in its quantitative trading programs; New York Attorney General Eric Schneiderman alleged it enabled the asset-management firm to tap into nonpublic information.

Further complicating matters, elected officials are expected to discuss important issues with members of the public, points out Indiana University Maurer School of Law professor Donna Nagy. So disclosures that could raise legal issues if made by a CEO to an analyst might not if they came from a politician.

Yet the research findings suggest campaign contributions lead to too cozy a relationship between politicians and analysts. That doesn't just have the potential to distort politics, it may also skew markets.

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