Testimony Before the Senate Commerce Subcommittee on Consumer Affairs

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Mr. Chairman, Members of the Committee, and esteemed guests:

Good Morning. I am William H. Mann, Senior Analyst for The Motley Fool. As it is not often that a Fool gets the chance to address the United States Senate, I am honored by the invitation to speak before you today about Enron – an situation that will no doubt go down in history as one of the largest, most destructive company failures of all time.

The Motley Fool was founded in 1993 with a mission to educate, amuse and enrich individual investors. Our work is driven by our belief that average people – you and I – ought to take a more active interest in our management of money. In order for individual investors to effectively engage themselves, they need education about how the financial system works, access to information, and opportunities for open dialogue. That's what we provide. We teach people the fundamentals of long-term financial management; we highlight online and offline information resources for them; and we manage a 24-hour open network of communication on the topic of money shared by people in more than 100 countries around the globe.

In addition, individual investors need to have trust in the marketplace. Congress and the SEC have actively supported education programs and disclosure practices that have helped to strengthen the confidence that individual investors have in the public markets. One statistic that should make us all proud is that while in 1990 less than a quarter of all American households directly owned stocks, today that number has grown to more than 50%.

Let me say at the outset that what was missing in the case of Enron was skepticism. Investors -- individual and institutional alike -- piled millions of investment dollars into the company, mesmerized by its growth rates, and completely sold on what seemed to be an insurmountable business advantage. Even though Enron emitted plenty of hints of impropriety for several years, few people, from Wall Street analysts to individual investors stopped to ask tough questions. I'd like to discuss those hints, the questions, and what I believe is the mechanism that allowed an Enron to slip through the cracks.

The Motley Fool's message was not adopted in a vacuum. Our founding was predicated on the fact that there was no one who had an incentive to tell people the truth about money and their investments. Part of the reason that we began teaching about the stock market was the amount of poor and self-interested advice that was being issued by brokerages and their analysts. To this day, the majority of stockbrokers are compensated on the number of trades their customers make, not on the returns they generate for them or on the quality of the advice they provide. We believe that the price targets and analyst ratings are made with several masters in mind, none of whom are the individual investor. In a similar fashion, sell-side stock analysts are generally compensated based upon the overall profitability of their firms, not the quality or accuracy of their analysis. In the end, analysts have minimal structural incentive to be accurate in their predictions; rather their built-in incentive is to be as favorable to their corporate clients as possible. It is a well-worn joke that there is no word as infrequently used on Wall Street as "sell".

An April 1999 speech from U.S. Securities & Exchange Commission Chairman Arthur Levitt cited a study that found sell recommendations account for just 1.4 percent of all analysts' recommendations, compared to 68% of all recommendations being buys. In the case of Enron, in September there were 17 analysts who covered Enron, and of them, 16 had a “buy” or “Strong buy” rating, one had a “hold”, and none had a “sell” or a “strong sell”. This was true after Enron's CEO, Jeff Skilling, suddenly resigned, and the company's stock had already lost some 60% of its value from its high of the year.

I do not wish to blame the Wall Street analysts for the Enron implosion. The blame for the billions of dollars that hundreds of thousands of investors lost lies almost entirely upon the senior management of Enron. But Enron was playing a game that is utterly corruptible in ways that are not transparent to retail investors, and the playing field is dominated by Wall Street firms, their analysts serving as the public face. I submit that every single gross mis-pricing in equities over the last decade has come with analysts cheering it on the way up and maintaining silence as it dropped. I use the word corruptible because, for all of the exhortations of The Motley Fool that investors ignore analyst ratings, there can be no question that people remain deeply influenced by them. The problem lies in the fact that analysts have a much greater incentive to focus upon the positive of a company than to root out the risks and the negatives, and their employers value their ability to generate investment-banking income much more than they do proper analysis.

I wish that I could say that I had sniffed out trouble at Enron when I did my analysis in 2000. I was really intrigued by the company, and did not want to miss out on what already was a spectacular growth story. But what I found was just confusing, and there were a few items that made me uncomfortable. In particular, Footnote 16 in their 2000 Form 10-K, under the heading "Related Party Transactions", where Enron disclosed that it had entered into a deal with LJM Cayman Corporation, stating that "A senior officer of Enron is the managing member of LJM's general partner." Under Generally Accepted Accounting Practices, disclosing a related party transaction is properly done in this fashion. However, related party transactions are also a method that companies use to "groom" their financials, so I would generally insist upon a high level of disclosure for the risks and benefits to shareholders that such a transaction would provide. Related party transactions are ideal vehicles for companies to hide risk, to get debts off of the balance sheet by using Special Purpose Entities (SPE's).

In Enron's case, the disclosures were minimal. When James Chanos, a famous short-seller, began asking questions that needed to be asked about these statements, no analysts followed up. When Enron routinely failed to provide a balance sheet along with its earnings releases for company conference calls, none of the analysts voiced much complaint, or if they did, it was not reflected in their ratings of the stock. Enron was a "black box" company, where no one, not the analysts nor any of the institutional or individual investors was really sure how the company made money.

There is no "smoking gun" with Enron. The financials looked great, so even now there is no single item that one can look at and say, "that was the tip-off", or "there is the sign that the company was going to implode." However, the more important issue is whether or not analysts have any incentive at all to do the analysis and to ask the tough questions. It strains credulity to say that, of the 17 analysts who covered Enron, that none of them had any idea that Related Party Transactions *could* be used to massage earnings or to hide debt. Enron's business was complicated enough, its financials convoluted enough, its disclosures opaque enough, and its sales growth spectacular enough that there ought to have been some pointed questions from analysts so that they could provide knowledgeable guidance to their shareholding clients. Which thus begs the question, "Why weren't there?"

Goldman Sachs analysts David Maccarrone and David Fleischer issued a report on October 24, 2001, following Enron's conference call to address investor concerns. Some of the quotes in the report are as follow "Lack of Disclosure and Transparency – A Longstanding Enron Hallmark." "New disclosure about related party transactions and structured off-balance sheet transactions occurred some 18 months ago…" "However, an undercurrent of concern began and grew as questions remained unanswered…" "We do not believe that management has done anything wrong…" Despite a lack of visibility into some pretty important risk factors at Enron, Goldman's analysts continued to keep Enron on its "recommended list", Goldman's highest rating.

At the same time, the Lehman Brothers analyst covering Enron put out his own version of the conference call. He called it "an inadequate defense of the balance sheet", but then concluded "despite the disappointing call we continue to think the stock should be bought aggressively at these levels". Lehman Brothers also kept their highest rating on the stock.

I do not believe that analysts should be taken to task for being wrong. In an environment where people are expected to take past and current trends and predict the future, getting things wrong would be an inevitable reality of the business. As Yogi Berra once noted, "It's hard to make predictions, especially about the future." The issue here is that the analysts who covered Enron, despite the company's long standing policy of withholding key information, and despite knowledge of the fact that there was an unknown level of debt being hidden from them in off-balance sheet SPE's remained nearly uniformly positive on the company until it was clear the company would collapse.

Both Lehman Brothers and Goldman Sachs have provided significant investment banking services to Enron. In the case of Goldman Sachs, the company provided financial services, sold or managed the sale of Enron commercial paper, and managed a public offering of its stock, all within the last three years. Lehman Brothers, for its part, also managed a public offering in Enron stock, plus a Lehman employee is an Enron director.

These investment banking activities comprise a much larger component of Lehman Brothers and

Goldman Sachs revenues and profits than do their retail brokering activities. Story after story in the media have shown that these analysts are having their compensation much more closely tied to the ability of their banks to provide these investment banking deals. Morgan Stanley analyst Mary Meeker, for example, had an "outperform" rating on all of the Internet stocks in December 2000, though they were down by an average of 83% from their highs of the year. The vast majority of these companies had received investment banking services from Morgan Stanley.

JP Morgan's head of equity research, Peter Houghton, sent a memo to the bank's equity analysts in March of this year stating that the analysts were required to consult both the company concerned and Morgan's investment banker before publishing research that regarded one of Morgan's corporate clients.

This environment ought to call into question the integrity of analyst research. The Enron collapse is neither the first nor the most expensive loss of shareholder capital that came while analysts maintained cheery ratings on a company. It's only by virtue of the fact that the loss on Enron shares has approached 100% for shareholders that made it the most noteworthy.

Lucent's struggles, although less apocalyptic so far, reinforces my point about sell-side analysts' failings. In January 2000, Lucent Technologies had a market capitalization well in excess of $240 billion. It was, by a significant margin, the most widely held stock in America. You only needed to understand one simple principle of financial analysis to see that trouble was coming for Lucent -- namely, that growth in inventory and accounts receivable should be no faster than growth in sales. For four consecutive quarters in 1999, both receivables and inventories at Lucent were growing at double, triple, even four times sales. And yet, of the 38 analysts who covered Lucent in January 2000, 32 had "buy" or "Strong buy" ratings on the stock, 6 had "hold", and none had a "sell" rating. Many of these analysts are employed by investment banks that had generated significant revenues from Lucent's acquisition and debt placement activities. Not one pointed out that the company's receivables or inventories were skyrocketing. Lucent's weak balance sheet has nearly bankrupted the company. This year it has laid off more than 60,000 employees, and in the last 22 months more than $200 billion of market cap has been erased.

Prior to January 2000, Lucent had never failed to meet Wall Street's estimates. It would seem that this fact, not the convolutions that Lucent needed to *meet* these estimates, was what was valued on Wall Street. Those convolutions have conspired to nearly destroy the keeper of Bell Laboratories, one of the treasures of American ingenuity.

Enron collapsed because its management got caught up in playing Wall Street's estimates game, promising and delivering big revenue and profit growth, regardless of the debt and other balance sheet contortions it took to get there. Individual investors lost money, in part, because analysts had limited incentives to look at the company's financials with critical eyes. Management withheld key information from shareholders, and then, even after the troubles came to light last month, refused to answer questions about the nature of its deals with partnerships that were controlled by Enron executives. Looked at in this way, the pursuit of hypergrowth seems to have caused Enron executives to take undue risks with shareholder funds. Maintaining Enron's (and its managers') darling status in the investment world apparently caused these same men to take that short walk across the aisle from being aggressive with company assets to being downright deceptive by hiding information individual and institutional shareholders *must* have to make good investment decisions.

Enron's management walked the fine line between keeping analysts happy and providing good information to their shareholders for years. Then Enron's management apparently made the conscious choice to place the appearance of high-profits, high-growth and low-risk -- things held dear by Wall Street -- over proper disclosure of risks and realities to their shareholders.

At The Motley Fool, our advice to investors is and has always been to ignore the “noise” that comes from Wall Street, and to treat any specific recommendations for stock purchase with skepticism. Meaning that things such as one-year price targets, which are the language of sell-side analysts, ought to be of no interest to an individual investor. We teach investors to think like business owners, not renters or passive pushers of paper. It is our genuine hope that investors seek to buy companies that they truly understand and would be willing to own for a lifetime. If there is one lesson that individual investors must learn from Enron, that is: Buy What You Know. Enron’s CEO Ken Lay has admitted that he himself did not fully understand the inner workings of Enron, and we can assume that he at least had all of the information. Even with full disclosure, Enron would have been a tough company for the majority of all investors to understand. The company was unapologetic in its refusal to provide information about its equity and debt structures for years before it actually blew up. My hope is that investors take the lesson offered by Enron and remain healthy skeptics in the future: when a company fails to treat shareholders as co-owners, one should assume that those components which are hidden from view do not contain good news.

Conclusion

There is a simple calculus that investors use in valuing a company. A company is fairly valued by all of its future profits discounted for risk. Obviously, the greater the risk to profits, the higher the discount should be, and less valuable every expected dollar of future profits would be *right now*. Over the last 12 months 233 public companies have had to restate their earnings, and not surprisingly, none of these restatements have made the companies' operating results look *better*. Getting away with falsifying earnings over a long period of time is difficult. It is much easier to falsify levels of risk and this, in the end, is what Enron, and by extension, its auditors and the analysts have done, by commission or by omission.

Individual investors have seen great strides in the level of protection afforded in the US stock markets over the last decade. Information technology and the Internet went a long way toward making public documents, including SEC filings, available at an instant to the vast majority of shareholders. Regulatory improvements such as Regulation Fair Disclosure have gone even further to ensure that companies provide fair and equal access to information vital for people to make investing decisions. We hope to see that work continued and support all efforts to increase financial education in America.

In a pari-mutuel environment such as a stock market, where every decision to buy, sell, or do nothing has a small effect on every other participant in the market, there is little chance that anyone will be able to provide absolute protection from bad information, whether intentionally or accidentally disseminated. However, the markets are built on trust, and there is a reason far beyond the power of American commerce that causes more than 48% of the world's equity capital to be represented here: investors the world wide know that their financial interests are better protected in the US's relatively transparent markets than in any other country on earth. It is in our best interest to ensure that we eradicate corruption and keep our markets strong.

Thank you for your attention. I appreciate the opportunity to address the Committee, and I would be happy to answer any questions.

Submitted for further consideration:

- 10/24/2001 Goldman Sachs Research Report
- 10/24/2001 Lehman Bros. Research Report
- 3/21/2001 "JP Morgan Reins in Analysts," The Times, London.
- 11/30/2001 "Enron as Icarus," by William Mann.
- 1/13/2000 "Lessons From Lucent," by Matt Richey, Tom Gardner and William Mann.
- Comments from Individual Investors in Enron, submitted by members of The Motley Fool Community.