4 Dirty Secrets Bay Street Bankers Don’t Want You to Know

Description

For us Main Street investors, the world of high finance is a very strange place.

Ten years ago, I would have killed to spend every day working on Bay Street. There’s something very intoxicating about working in the heart of the business world, and it’s not just the money. These are the people that are running our very economy, much to the chagrin of the government.

But as I’ve gotten older, my view of Bay Street and high finance has soured. Sure, Bay Street is exciting and bankers make a lot of cash, but it’s a tough lifestyle.

There’s very little in empathy; an employee is only as good as his last deal. And the whole system is just designed to siphon off fees, whether they be from clueless investors or from companies forced to use the big banks as a middleman between them and the capital they need.

This is not a system that’s good for the individual investor. But that’s not even close to the end of it. Here are four more reasons why investors should be wary of anything that comes from Bay Street.

Buy ratings are useless

I highly recommend reading *Conspiracy of Fools*, Kurt Eichenwald’s extremely detailed look at the Enron collapse.

One thing Eichenwald mentions in the book is how Enron would use its clout to get analyst ratings changed. If an analyst from a bank would change their rating on Enron’s stock from a buy to a sell, the CFO would call up the bank and threaten to take the company’s investment banking business elsewhere. The bank capitulated every time.

Think of a company like **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) in this context. Because of its acquisition-heavy business model, it has tapped the public markets for billions in new debt and equity financing over the past few years, a trend that looks poised to continue.

Why would one of Canada’s top banks say anything negative about the company? They know that doing so will cost them millions in potential profits the next time Valeant goes to the market.

Think about that the next time you ponder an analyst's opinion.

Small caps are often better

Over the long term, small-cap stocks tend to outperform their larger cousins. In fact, Warren Buffett posted his best returns when he almost exclusively invested in small caps.

In the U.S., between 1926 and 2004, the return of small-cap value stocks beat large caps by more than 6% annually, returning 15.9% compared to 9.3%. That's the kind of outperformance I want in my portfolio.

And yet, Bay Street analysts often don't even cover companies smaller than $1 billion in market cap. Why? Because these companies are crummy customers for the investment banking business. If they're borrowing, it's not much. Thus, Bay Street ignores them.

Short-term thinking

Reports from analysts seem to all follow the same theme. They focus on short-term issues while ignoring good long-term prospects.

A recent example I can think of is **Manitoba Telecom Services Inc.** (TSX:MBT). Analysts focused on the company's pension issues and the possibility of an upcoming dividend cut, which helped push down the share price to $24. But they were ignoring positive long-term catalysts, including a potential sale of its Allstream division and a much better valuation compared with its peers.

Since then, shares of Manitoba Telecom have surged more than 20%, while its competitors haven't seen much gain at all.

Fees are killer

A big part of the Bay Street hype machine is dedicated to convincing investors outperforming the market is only a mutual fund away.

But the fees on the average mutual fund make them a poor choice for passive investors. ETFs are a much better option for the investor who doesn't want to pick individual stocks. Since ETFs don't generate much in fees, banks offer them, but that's about it. Fortunately for individual investors, there are plenty of independent sources that do a nice job covering why fund fees are bad and why ETFs are the better choice.

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