The Rise And Fall Of The Physician Practice Management Industry

Can Wall Street efficiently value health care?

by Uwe E. Reinhardt

PROLOGUE: “Ivory-tower teachers of finance,” says Uwe Reinhardt, have been trying for years to drum a simple lesson into their students’ heads: To enhance value for shareholders, the return on an acquisition must exceed the company’s weighted average cost. Simple lessons like these seem to have eluded participants in the frenzy surrounding the creation—and subsequent collapse—of the physician practice management (PPM) industry. Observers have described PPM firms as “Ponzi schemes” involving investment bankers, initial investors, venture capitalists, physicians, and others. Regardless of how the industry is characterized, the facts are clear: Between December 1997 and September 1998 Wall Street’s valuation of the fifteen largest PPM firms fell by 64 percent, and the entire industry lost as much as half of its commercial value.

In this paper Reinhardt uses the tale of that industry’s rise and fall to illustrate how Wall Street values stocks and Wall Street’s ability to allocate resources efficiently. He is critical of Wall Street securities analysts, whose job it is to sift through the reams of information and assist their clients in making appropriate decisions.

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ABSTRACT: The dominant view among academic economists is that the financial markets value financial securities “efficiently,” in the sense that the prevailing prices of widely traded securities fully and properly reflect, at any time, all publicly available information that bears on these securities. Although that theory has great intuitive appeal, it requires intellectual effort to reconcile it with the rise and fall of the physician practice management industry. This paper explores how acquisition-driven firms are valued in the financial markets and what structural factors may stand in the way of truly efficient security valuation.

Economists are fond of saying that financial markets are “price-efficient” in the following sense: At any time the prevailing market prices of financial securities properly reflect the available information that bears on the value of these securities. It follows that any future changes in that value must reflect information that is not yet available.

In its strongest form, this so-called efficient-market hypothesis holds that current securities prices reflect all pertinent information, whether publicly available or not. That appears implausible on its face. It would mean that even traders with inside information could not earn abnormal risk-adjusted returns by acting on that information. In fact, the strong version lacks persuasive empirical support.¹

In a form that is less strong, the hypothesis holds that current market prices of securities properly reflect all pertinent publicly available information. The popularity of this form of the hypothesis among economists is based on the fact that the publicly available information on securities is cheaply accessible and shared by literally thousands of securities analysts and traders, many of whom preside over funds with billions of dollars to take advantage of mispriced securities.² Indeed, over the years I have been impressed by the high intelligence and energy found among the analysts who follow the securities of firms in the complex field of health care. They grasp the theory of corporation finance, the principles of health insurance, and the economics of health care delivery. Most of them also have a solid understanding of public health policy, both state and federal. In periodic research reports they present a far-flung, well-structured array of accurate financial and collateral information about pertinent facets of the health system. Even if one may not always share their assessment of the impact of this information on the value of the securities being analyzed, the fundamental information they assemble in these reports can be a useful input into one’s own attempts to put proper values on financial securities.³

Although for these reasons the semistrong form of the efficient-market hypothesis has great intuitive appeal—certainly to economists—its empirical support remains mixed.⁴ As economist Louis Gapenski notes, “Many theorists, and even more Wall Street ana-
lysts, believe that ‘pockets of [pricing] inefficiency’ do exist [and that] in some cases entire markets are inefficient.” Not surprisingly, the semistrong hypothesis finds stronger empirical support for widely followed and traded securities of large firms than for smaller or newer firms that are not widely followed or traded. Many health care enterprises fall into the latter category, as, of course, do many high-tech and Internet companies.

The stunning rise and fall of the physician practice management (PPM) industry during this decade may well have been an example of such a “pocket of inefficiency.” In the early 1990s the industry was hailed as the capitalist salvation of a moribund cottage industry starved for financial capital and managerial expertise. Some financial analysts now ruefully concede that the now moribund PPM industry functioned as “purely a consolidation game functioning similar to a pyramid scheme.” If that is so, it is fair to ask why the financial markets cheered these pyramid schemes on so ebulliently.

This essay offers two propositions on the valuation of financial securities, notably stock certificates. First, even in the best hands these valuations represent a daunting task that is subject to wide margins of error. Second, however, the inverted U-shape traced out by so many security prices—especially in health care, and particularly in the PPM industry—do make one wonder how well the financial markets actually perform their daunting task.

**Textbook Models Of Securities Valuation**

Financial securities—for example, bonds or ownership certificates (stocks)—specify legally enforceable rights to the future cash flows generated by the enterprise that issued them. According to standard financial theory, the market value of a security is the present-value equivalent of the entire future cash flow that the security’s owner can reasonably expect to receive, with the emphasis on “cash.”

The interest rate (discount rate) used to convert future cash flows into their present-value equivalent reflects the rate of return that investors could have earned on a risk-free investment (for example, inflation-indexed U.S. Treasury bonds), plus a premium to compensate them for assuming the inherent risk. Given a projected cash flow from the security, the higher its perceived risk to investors, the higher will be the discount rate used in its valuation and the lower will be the bid prices offered by potential investors.

To illustrate this method of securities valuation, consider an enterprise whose annual earnings per share (EPS) of common stock outstanding are expected to grow at an annual compound rate of 20 percent for N years, whereafter growth is expected to settle down at a more moderate rate of 6 percent in perpetuity. It is assumed that
during the rapid-growth phase the firm will distribute to owners only 10 percent of earnings in the form of cash dividends. That dividend payout ratio is assumed to be 60 percent thereafter. The expected future resale price of the stock at the end of the investor’s investment horizon must depend on the future dividends that investors then will project beyond that investment horizon, and so on for future investment horizons. Therefore, the future cash flow expected per share of stock in such models is represented simply as a perpetually growing flow of expected cash dividends per share. Although necessarily stylized, this model can be used to highlight several important points about the value of growth stocks.

Exhibit 1 shows the price/earnings (PE) ratio (price per share divided by current earnings per share) that rational investors would pay for this stock under alternative assumptions. It illustrates the high sensitivity of the PE ratio to changes in (1) the number of years during which growth is expected to be rapid, and (2) the discount rate at which projected future dividends would be converted into their present-value equivalents (which, in turn, depends on the mood of investors). In Exhibit 2 it is assumed that the rapid-growth phase is a fixed ten years. At the low discount rates at which American stocks now seem to be valued on Wall Street, changes in the assumed growth rate during the rapid-growth phase can powerfully drive these warranted PE ratios. It can explain why they often jump so much in response to new information on earnings or rates.

Two important points emerge from this. First, the monetary value of any asset is strictly a product of human imagination and emotion.

<table>
<thead>
<tr>
<th>Discount rate</th>
<th>Number of years of rapid growth</th>
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<tbody>
<tr>
<td></td>
<td>5 years</td>
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<tr>
<td>8%</td>
<td>54.5</td>
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<tr>
<td>9%</td>
<td>35.0</td>
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<td>10%</td>
<td>25.2</td>
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<tr>
<td>11%</td>
<td>19.4</td>
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<td>12%</td>
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<td>6.3</td>
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<tr>
<td>19%</td>
<td>5.6</td>
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<tr>
<td>20%</td>
<td>5.0</td>
</tr>
</tbody>
</table>

**SOURCE:** Author’s analysis.
It rests solely on expectations about the asset’s future cash flow and on highly subjective evaluations of the inherent risk. Second, at any time any group of securities analysts could justify a range of estimated values for a given stock, even if each duly and diligently sought to establish best, unbiased estimates of an enterprise’s value. The margin for honest error is large.

**Stock Valuation In Practice**

In practice, a so-called fundamental financial valuation of a firm’s common stock fuses information about the firm’s environment—the markets for its inputs and products as well as the regulatory strictures within which it operates—with information about the firm itself. The analyst then develops projections of the firm’s future earnings per share on which financial analysts base their stock valuations, with analytic methods that vary greatly in sophistication.

- **Quality of information about the firm.** Central to information about the firm are its financial reports for the past several years, along with the collateral information that management disseminates through press releases, in presentations at special investors’ conferences, during periodic conference calls with stock analysts, and in one-on-one conversations with particular analysts (which by themselves can lead to conflicts of interest through favoritism). Evidently, a management paid largely with the firm’s stock or options on that stock has powerful incentives to put the rosiest gloss on that information and to “manage” reported earnings so as always to meet or slightly surpass Wall Street’s expectations.

Unfortunately, the Generally Accepted Accounting Principles (GAAP) promulgated by the Financial Accounting Standards Board (FASB) are flexible enough to allow managers wide leeway in moving revenues and expenses through time, which makes it easy to manage annual earnings strategically, at least in the short run. But in their hunt for earnings that can be reported, some managers have

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**EXHIBIT 2**

**Sensitivity Of Stock Prices To Changes In The Growth Rate Of Future Earnings (Warranted Price/Earnings Ratio)**

<table>
<thead>
<tr>
<th>Growth rate</th>
<th>Assumed discount rate for valuation</th>
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<tbody>
<tr>
<td></td>
<td>8 percent</td>
</tr>
<tr>
<td>8%</td>
<td>31.8</td>
</tr>
<tr>
<td>12%</td>
<td>46.5</td>
</tr>
<tr>
<td>16%</td>
<td>65.9</td>
</tr>
<tr>
<td>20%</td>
<td>92.3</td>
</tr>
</tbody>
</table>

**SOURCE:** Author’s analysis.
**NOTE:** Rapid-growth phase is assumed to be ten years.
resorted to outright fraud, creating reported earnings out of thin air, right under the noses of outside auditors. Centennial Technologies Inc. has done so. Before it was bought by the pharmaceutical wholesaler McKesson, software producer HBO and Company had done so. CUC Inc. did so before it was bought by Cendant Corporation. So unreliable has business accounting become that Securities and Exchange Commission (SEC) Chairman Arthur Levitt now threatens the practitioners of creative accounting with jail terms.

In theory, financial analysts are paid to cut through the fog of disinformation emanating from management. How diligent their research actually is and what they really are paid for are matters of debate. But even the diligent can fall victim to unscrupulous managements, especially when management works with the tacit approval of the firm’s outside auditor. Due diligence notwithstanding, in the end a financial analyst remains but an outsider.

**Accretive acquisitions and funny money.** A firm can elicit from the financial markets an unrealistically high stock valuation through a judiciously staged program of acquiring the existing earnings of other enterprises—even those with relatively sluggish earnings prospects. The trick is to structure these deals as what Wall Street calls “accretive”—that is, so that they drive up the acquiring company’s earnings per share immediately. It has been the central business strategy of the so-called roll-ups, among them the now deeply troubled PPM industry. To understand why this game so often drives stock prices along the path of an inverted U, it is useful to explore the mechanics of accretive mergers in more detail.

A business acquisition will be accretive if the acquiring firm uses cash on hand to acquire another company’s earnings. The acquiring company’s earnings will increase, but the number of its shares outstanding will not. If cash is not available, accretion can be had through debt-financed deals, but only if the after-tax cost of the new debt is smaller than the after-tax earnings of the acquired company. The use of debt, however, burdens the acquirer with fixed future interest payments that can spell disaster in periods of revenue downturns. FPA Medical Management, a PPM firm that financed its early acquisitions of clinics that way, ultimately declared bankruptcy when it failed to meet debt obligations.

To minimize the potential of bankruptcy, business acquisitions often are financed with the acquiring company’s own stock. Such acquisitions will be immediately accretive to the acquirer’s EPS if (and only if) the acquiring company pays for the earnings of the acquired entity a PE ratio (in terms of the market value of the acquiring company’s stock) that is lower than the PE ratio at which the market values the acquiring company’s stock.
To illustrate, if the stock of Apex Inc. trades at forty times earnings and Apex pays the shareholders of some acquired entity with newly issued Apex stock that has a market value of $30 per $1 of earnings of the acquired entity (that is, if Apex pays a PE ratio of 30 for the acquired earnings), then Apex’s postmerger EPS will be larger than its premerger EPS. The deal would be accretive. If Apex paid $50 worth of Apex stock per $1 of the acquired entity’s earnings, then Apex’s postmerger EPS would be lower than its premerger EPS. The deal would be dilutive. It will always be so, regardless of the relative sizes of the entities’ premerger earnings.

Exhibit 3 illustrates how a properly staged program of accretive, stock-financed acquisitions can temporarily give the acquiring company the image of a high-growth company. Suppose that with the assets it already owns, Apex’s EPS would grow along path A. If at time 0 Apex’s management had promised Wall Street an EPS of W for period 1, Apex could deliver on that promise if during period 1 it acquired another company in an accretive stock-financed deal. If that entity could be had relatively cheaply, however, its earnings probably were expected to grow more slowly than Apex’s own EPS would have grown in the absence of the merger (path A). It follows that if Apex stopped acquiring other entities after this first merger, its same-store EPS probably would have grown along the lower path B. To avoid that embarrassing fate, Apex could acquire in period 2 one or two other entities, once again at PE ratios lower than its own, thereby driving its EPS for period 2 to level X. If Apex then stopped its acquisition program, its same-store EPS probably would follow...
the slow-growth path C. That fate, in turn, could be avoided by acquiring yet more relatively “cheap” entities, which might drive Apex’s EPS for period 3 up to level Y, and so on.

The earnings acquired in this exercise are not phony; they are real and valuable, as long as the acquired company’s financial reports had been honest. The trick is to seduce the financial markets into the belief that the acquisition binge will continue apace for a long time, so that the heavy future growth path (dashes in Exhibit 3) is believed to be the proper basis for valuing the company’s stock. Remarkably, this strategy often seems to work. The problem, however, is that to stay on the projected, acquisition-driven growth path, the acquirer needs to make an ever-larger number of accretive acquisitions, year after year. Sooner or later in that quest, two untoward things are likely to happen.

First, in its frantic acquisition binge, the acquirer will eventually throw due diligence to the wind and buy some real lemons. In its heyday, for example, FPA Medical Management boasted that it was making an acquisition every quarter. After its bankruptcy, the new chief executive ruefully conceded that many of them did not perform, draining the company’s resources. Second, sooner or later the well of “cheap” acquisitions will run dry. Thereafter, the acquirer’s EPS will have to grow largely from same-store growth, and that “growth” often turns out to be negative.

It turns negative because, to management’s apparent surprise, the economies of scale and scope (known on Wall Street as “synergism” or the “two plus two equals five” effect) promised for every new acquisition usually do not materialize. On the contrary, the varied corporate cultures and incompatible information systems of the helter-skelter mosaic tend to create negative synergism—a “two plus two equals three” effect. To pay for the negative synergism wrought by management, the squeeze is put on the labor force, which becomes demoralized. Highly productive employees may look for greener pastures. Ultimately, there follows a major balance-sheet laundry—that is, enormous write-offs that are delicately labeled as “nonrecurring charges for restructuring and consolidation.”

The financial markets often greet such write-offs by raising the firm’s stock price, because management courageously spun off or closed down the junk that had been bought earlier to “concentrate on the company’s strong core business.” Just as often, however, the company’s stock takes a dive, as soon as the first analyst wakes up and savvy short-sellers begin to cash in. Left holding the bag are the last hapless investors who came late to this application of the famous Greater Fools Theory and surrendered valuable cash or other real assets for the acquirer’s now devalued funny money.
Corporate executives would find it more difficult to play this game if the outside auditors of financial reports took more seriously the meaning of “audit,” and if Wall Street analysts took more seriously the meaning of the term “due diligence.” Part of the latter would be to discount more heavily the ephemeral nature of acquisition-driven growth. Curiously, the important distinction between internal (same-store) and external (acquisition-driven) growth seems to get lost in the frantic dance of mutual admiration between company executives and the financial markets. As one of the more astute Wall Street analysts has remarked on this point:

We have always found that analyzing companies that grow through acquisitions difficult...The potential implications of this type of growth strategy have been ignored by many analysts and company management...First, the continuation of this strategy is predicated on the maintenance of high-value stock to make accretive acquisitions. Second, an accretive acquisition does not necessarily enhance shareholder value. For example, it assumes that the acquiring company's cost of capital is the ratio of its earnings per share to its stock price (the inverse of the P/E ratio)...However, it is necessary for the return [on the acquisition] to exceed the company's weighted average cost to enhance shareholder value (emphasis added)."11

This is not intended to downplay the difficulties of valuing acquisition-driven growth. It is challenging to predict when an acquisition drive will have run its course. In the face of that uncertainty, security analysts would do well to produce sensitivity analyses, such as that presented in Exhibit 2. Although that, too, relies on a set of specific assumptions, it does serve to highlight clearly the enormous risk inherent in growth stocks.

**Funny-Money Games And The PPM Saga**

Although the full history of the PPM industry has yet to unfold, it is now generally agreed that its rapid recent rise and fall during the past decade was driven mainly by pyramidal funny-money games. The business model originally promised by the industry had been heralded in the early 1990s as a vehicle for endowing physicians with the financial capital they would need to harvest the synergism of larger groups; to build sophisticated clinical information systems that would help physicians to manage care more efficiently; and to develop as countervailing power against the growing market clout of the managed care industry. The advertised idea was to create genuine value that could be shared at least by physicians and their capitalist allies in the financial markets, but perhaps also by patients, in the form of lower prices or higher quality or both.

On paper, it is an attractive business strategy, and it might work in practice, if physicians were made partners rather than salaried employees, if the management fees charged the physicians were matched by valuable management services rendered them, and if the
“The entire PPM industry lost more than half of the commercial value that Wall Street had detected scarcely a year before.”

PPM company itself were built on a fully developed information infrastructure. The question is whether Wall Street will be able to muster the patience to finance such a strategy and, if not, who might.

Be that as it may, much of the PPM industry now lies in shambles. Only two months after James Robinson published in this journal an upbeat prognosis on the future of the industry (although with a hint that “short-term financial imperatives” posed some risk), in 1998 Morgan Stanley Dean Witter analyst Todd Richter flatly concluded that “the PPM sector has collapsed over the past six months.”

Between December 1997 and September 1998 Wall Street’s valuation of the fifteen largest PPM firms fell by 64 percent, from $10.6 billion to $3.8 billion. Overall, the entire PPM industry was estimated to have lost over this period more than half of the commercial value that Wall Street had detected in it scarcely a year before.

In a euphoric report on the PPM industry, issued as late as December 1996, research analysts of one well-known investment house stated that “among independent PPMs, the large, multispecialty companies—particularly MedPartners and Phycor—stand out for being best positioned to succeed in a rapidly evolving market.” (The mantra now is that only single-specialty PPM companies are viable.) MedPartners and Phycor then were forecast to generate “60–65 percent of aggregate earnings growth through 2000 from acquisitions” (emphasis added). These analysts concluded that “with a minimum of capital investment compared to the cost of acquiring practices, FPA will profit over the next three-to-five years by adding significant management infrastructure to IPAs.” Presumably, the “minimum of capital” refers to the fact that neither cash nor debt was expected to be used in FPA’s stock-financed acquisition binge.

FPA declared bankruptcy in July 1998, when it ran out of cash to meet debt services and when it was discovered that little if anything had been done to “add any significant management infrastructure” to the company. On the contrary, the verdict now seems to be that the task of managing the fast-growing company was over the head of its original founders. It is fair to inquire about the research analysts’ source of the optimistic information on FPA’s heralded “management infrastructure.” Was it one of those conference calls at which management gave analysts “guidance,” or did the analysts “kick the tires,” perhaps by contacting physicians in the field to inquire about the quality of FPA’s managerial services?
For its part, the much-praised MedPartners had by October 1998 lost about 83 percent of the market value that Wall Street had assigned it only ten months earlier. Far from becoming one of the expected leaders of the PPM industry, MedPartners shortly thereafter exited the PPM business altogether. In regard to Phycor, the previously cited research analysts had concluded that “given the company’s potential to grow earnings 30–35 percent per year over the next five years...and an accelerating pace of acquisitions, Phycor is modestly undervalued with a fair market value of $35 to $40, and is rated outperform” (emphasis added). Investors who believed that sanguine valuation and bought Phycor stock at about $28 a share in December 1996 held a value of $5 per share in July 1999.

The postmortems on this remarkable phase of the PPM industry will undoubtedly continue years into the future. So far the consensus seems to be that whatever other errors the industry committed, a major source of its problem was that it tried to grow mindlessly fast, in a fatal pas de deux with a financial market that egged the industry on with unrealistic expectations about future earnings.

Gerry Benedict, a consultant with Medimetrix and former administrator of a clinic, rightly concluded that “some PPMs (MedPartners included) were created as Ponzi schemes with several parties collaborating—investment bankers, PPM founders and management, initial investors, venture capitalists and physicians.” Research analysts at Piper Jaffray, a major brokerage house, had once shared Wall Street’s general euphoria about PPM firms but have since come to conclude that the industry’s ostensible basic business model may not be practical after all and that ultimately the PPM industry degenerated into a pyramid scheme. Far from creating value, these analysts conclude, the “PPMs will add cost into the health care system by adding another layer.”

Salomon Smith Barney analyst Lawrence Marsh sought to extract lessons from the managerial errors of four PPM firms: “First, there is quite a challenge involved in marrying the short-term horizon of investors’ expectations for the PPM industry with the longer-term horizon of attempting to change physicians’ behavior and practice patterns...Sometimes a PPM's stock price actually drives a company's operating decisions, for example, to grow quickly through affiliations and acquisitions.” In my view, that is a tactful way of describing the funny-money game illustrated above.

**The Mysterious Role Of Securities Analysts**

As noted, an economist’s intellectual bias is to believe that financial markets price securities efficiently in the sense that the prevailing price of a security always properly reflects all pertinent, publicly
available information. Unfortunately, it is not easy to reconcile that hypothesis with the saga of the PPM industry and with the many other bizarre vignettes regularly played out in the financial markets.

A kind interpretation is that analysts and traders in the financial markets dispassionately watch as incompetent or unscrupulous managers take an originally sound business concept and trash it through their fondness for quick-buck pyramid schemes and their inability to manage operations. On that interpretation, the inverted-U curves traced out by the stock prices of such enterprises merely reflect the analysts’ objective and efficient scoring of commercial value being first created and then destroyed.

An alternative interpretation, however, is that the managers in the real sector of the economy too frequently dance to a tune composed mainly by financial markets that put a premium on predictably smooth, rapid growth in earnings per share, however “managed.” In a scathing address entitled “The Numbers Game,” SEC Chairman Levitt last fall declared open war upon what he called “a game that runs counter to the very principles behind our market’s strength and success.” He continued:

Too many corporate managers, auditors, and analysts are participating in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation...and integrity may be losing out to illusion.

Coming from as distinguished and intimate an observer of financial markets as is Levitt, this criticism is not easily dismissed. In this connection, it must be noted that the felicitous spin many securities analysts tend to put on the fundamental data they assemble is striking, and even more so are their optimistic earnings forecasts for acquisition-driven schemes. In general, the word “sell” is just too rare among these analysts to make their recommendations ring objective. In their lingo, even “buy” may signal “sell,” and “hold” may mean “outright disaster”! It can fairly be asked what objective drives this debauching of the English language.

In one of her columns (this one in Forbes) New York Times financial columnist Gretchen Morgensen offered this explanation:

A rosy research report can mean the difference between winning the lucrative manager’s spot on a debt or equity offering for a [Wall Street] company and not participating in the underwriting [of the new debt or equity issue] at all...If you are an analyst at a firm looking to get some of [these deals], which do you think will get you there quicker: a negative or a positive report?...Time was when analysts were paid a salary and a bonus based on trading revenues generated by their recommendations. Today most of an analyst’s compensation derives from investment banking revenues—fees earned by initial public offerings, secondary issues, debt offerings, even mergers and acquisitions.
Levitt’s and Morgenson’s comments, however, seem to be aimed strictly at securities analysts on the sell side of the market—those in brokerage houses and investment banks that retail the securities they buy wholesale from the issuing enterprises. As a peer reviewer of this essay (who identified him- or herself as a longtime securities analyst) remarked on the role of sell-side analysts in securities valuation, “With relatively few exceptions, the role of sell-side analysts is to sell underwritings. They are not unbiased and everyone knows it. This bias could lead to distortions if anyone actually relied on sell-side analysts. But no one does so exclusively.”

This comment draws attention to the buy side of the market, especially to the buy-side analysts who manage large mutual funds and other investment portfolios. If they routinely do discount the sell-side analysts’ spin, how could they have gone along so exuberantly with the wild run-ups of the ill-fated PPM companies or, for that matter, with the equally ill-fated roll-ups in other industries (for example, in office supplies, waste management, and funeral homes)? Why did they not put an earlier stop to the stock valuations that were driven by pyramid schemes, simply by refusing to invest their portfolios in these stocks in the first place?

An explanation may be found in the typically short investment horizons of portfolio managers. Usually, they do not have the luxury of conducting the well-researched buy-and-hold strategy described in textbooks. Instead, they find themselves publicly ranked in terms of quarterly portfolio rates of return, and these include both realized and unrealized capital gains. Although their compensation is usually not based directly on that rate of return relative to some benchmark—usually it is a percentage of the total asset value under their management—their compensation is linked indirectly to their rate-of-return performance, if money quickly leaves mutual funds that underperform relative to their benchmark rates of return.

This imperative to achieve high short-run capital gains makes it attractive for fund managers to follow a Greater Fools strategy under which they knowingly purchase what they judge to be overvalued securities, in the hope that they can benefit from a further, unwarranted run-up in value and profitably unload the stock to the proverbial “greater fool” sometime before its price ultimately collapses. From a human perspective, such a strategy of portfolio management is fully understandable, because with luck it can be profitable in the short run. Only Voltaire’s Dr. Pangloss, however, would call playing the Greater Fools strategy “efficient” pricing.

The author thanks the anonymous referees for their thorough reading of this paper and their many helpful suggestions.
NOTES

12. This is not always so, as the sorry recent history of Cendant and McKesson illustrates. In both cases, the acquired companies’ books were fraudulent.
13. Adherents to this theory knowingly purchase overvalued stock in the hope that an even greater fool will buy that stock at a still higher price.
19. Ibid., 1.
20. Ibid., 49.
22. On the role of these conference calls, see Konrad and Virshup, “Can You Trust Wall Street Analysts?”
25. Ibid., 9.
26. Ibid.
29. Ibid., 2.