

BEST PRACTICES FOR EQUITY RESEARCH ANALYSTS

ESSENTIALS FOR
BUY-SIDE
AND SELL-SIDE
ANALYSTS



Ensuring Every Stock Call Has Value

Avoiding Valuation and Stock-Picking Pitfalls

Getting Others to Act on Stock Recommendations

JAMES J. VALENTINE, CFA

BEST PRACTICES
FOR EQUITY
RESEARCH
ANALYSTS

Essentials for Buy-Side
and Sell-Side Analysts

JAMES J. VALENTINE, CFA



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To Emma, Laura, Alice, and Robert for their loving support.

If we knew what it was we were doing, it would not be called
research, would it?

—*Albert Einstein*

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Chapter 20

Overcome Challenges to Creating Discerning Stock Calls

I don't have any trading secrets that guarantee stock-picking success. If I did, I would be selfishly hoarding them on a private tropical island I'd purchase with the windfall. In truth, it's not that I haven't found them, but that they don't actually exist. Through my entire career working with hundreds of sell-side analysts at Wall Street's largest firms to the thousands of clients I've met, I've never come across a low-risk, high-return investment strategy that could be used with consistency. I mention this first because I find some analysts spending more time seeking this Holy Grail than producing high-quality fundamental research.

It's probably worth mentioning that the discussion in this section is limited to stock picking using a fundamental approach; I cover the technical approach later in Chapter 22. Many portfolio managers prefer their analysts not use both a fundamental and technical approach simultaneously, at least not until the fundamental work is done.

Stock picking is one of the few areas where sell-side analysts have it better than buy-side analysts. Both types of analysts are required to make stock calls, but sell-side analysts can have long and rewarding

careers even as mediocre stock pickers, because their clients aren't necessarily paying just for stock calls. With that said, sell-side analysts who are good at every other aspect of the job *and* can pick stocks are rewarded for these efforts. The buy-side isn't as forgiving, because stock picking is usually the major component in setting compensation.

Dennis Shea, who spent many years as a highly ranked sell-side analyst and a senior manager of both sell-side and buy-side analysts, has an insightful view about the qualities that make up a great stock picker:

- Dispassionate, namely, they don't allow nonrelevant factors to cloud their judgment.
- Stick to their discipline and strategy over the long-term.
- Self-aware of where they have expertise and where they don't.

Challenges with Stock Picking

It's important not to confuse valuation with stock picking. There were many people by mid-1998 who could clearly show technology stocks were overvalued, but their bearish calls would have been bad stock picks for another 18 months, well beyond the typical institutional investor's time horizon. Stock picking involves art and science. As highlighted in Exhibit I.1, the science part comprises the primary tasks discussed to this point: identifying critical factors, creating financial forecasts, and using valuation to derive a range of price targets. This last phase also has elements of science within it, but in order to truly achieve success, an analyst must learn the *art* of stock picking.

Experienced practitioners know stock picking is the hardest part of the job, in part due to these challenges:

- All of the information needed to make a perfect stock call is rarely available. My work shows that analysts appreciate this

concept more as their experience increases. After all, if the information were readily available, it would have already moved the stock. Thorough research helps give an analyst an edge over the broader market, but it's rarely complete or reliable enough to make a stock call with 100 percent certainty.

- As an analyst diligently takes more time to dig deeply into an investment controversy, the early stages of research often become known by the market, thus diminishing the value of the work. Unlike scientists and doctors who can research topics for years, analysts need to balance relative urgency with the need for more thorough research.
- There isn't always a great stock-picking opportunity in an analyst's space. Despite conducting thorough research, there may not be a big call at a given point in time, because the market has reasonably assessed the critical factors that drive a particular stock.
- Some factors that move stocks can't be forecast. Many analysts had well-researched individual stock recommendations in mid-2008 that completely fell apart due to the subprime-led global financial collapse. These "black swans," which can't be forecast, can disrupt what would otherwise be a great stock call.
- Many analysts are so overworked that they don't have time to find unique insights. As discussed earlier, many shops overload their analysts with so many stocks that the analyst only has time to play defensive catch-up, which means there's no time for creative thinking to generate alpha. If an analyst is only digesting information available to the rest of the market, it's going to be tough to beat the market.
- Emotions cloud clear thinking, often causing an analyst to make the wrong decision. This is discussed further in Chapter 21.

Where Do You Differ?

Put simply: *The key to generating alpha is having a more accurate view about a future stock price than the market.* This can only be done on a consistent basis if the analyst has an edge over the market in one of the three areas that compose our FaVeS™ framework:

- **Forecast:** Financial forecast superior to the market. (This relies on many of the best practices discussed earlier.)
- **Valuation:** Valuation methodology or valuation multiple superior to the market.
- **Sentiment:** Forecast of investor sentiment superior to the market. (Sentiment, void of any fundamental changes, is often the only thing that moves a stock or market in the short-term.)

That's it—nothing more. If you don't have an out-of-consensus view in one of these three areas, you don't have a stock call worth making. Unfortunately, this gets lost on too many analysts. Drew Jones, former associate director of research at Morgan Stanley, would tell analysts, "Don't assume you're smarter than the market. If you think the market is wrong, you need to have some proprietary piece of information or thesis that is not understood or known by the market." Given the importance of the three elements of the FaVeS framework, we explore them in more detail below.

Forecast Superior to the Market

Among the three elements of the FaVeS framework, new analysts are more likely to have success in developing a superior financial forecast than the other two components that take more time and experience to master. There are usually a good number of high-quality, experienced analysts who make up the consensus estimate for a company. Therefore, if an individual analyst's forecast is significantly out of consensus, the starting point should be to assume his forecast is wrong. Understanding why an analyst's estimate differs from consensus can be a time-consuming

task, but it's required before making a stock call. *It's critical to ensure that the "differentiated" element of a forecast is concentrated in an area of expertise or has been thoroughly researched, rather than being just a more bullish or cautious view.* It's for this reason that analysts should forecast upside, downside, and base-case scenarios before making a big stock call; it allows critical assumptions to be stress tested and forces the analyst to consider the other side of the trade. (See Chapter 18 for additional information.)

When a forecast is out of consensus, it's important to make sure the components of consensus are understood by asking these questions:

- How many analysts make up consensus? For forecasts that cover periods two to three years out, sometimes there are only a few published sell-side estimates, which is hardly a consensus view for most sectors.
- Where is the "informed consensus," which comprises the sell-side thought leaders, relative to the overall consensus? It's well understood in practice and has been proven in studies that some analysts are better at forecasting the future than others. (StarMine has a patented product, SmartEstimate, that places more weight on estimates from analysts with a more accurate forecast record.) How do their views differ from the broader consensus?
- Are the estimates stale? When the sell-side updates estimates after earnings season, it's not uncommon for there to be no major revisions for another two months until the next earnings season approaches. Being in possession of a financial forecast that differs substantially from a stale consensus may be valuable. Or it may be worthless because it's already accounted for in unpublished Street expectations.
- Are there any disagreements about what's in the number? Data vendors are getting better about this, but occasionally there is still a situation where some sell-side analysts are including something in their estimates that's excluded by everyone else.

If the above mechanical questions surrounding consensus are explored, and the analyst still has an out-of-consensus view, the next step is to understand why. A global director of research for a large sell-side firm tells analysts, “If you don’t know what’s in the price, you can’t justify why a stock will move to a new level.” This is one of the more difficult parts of the job, usually requiring conversations with individuals who are close to the stock on the buy-side, sell-side, and within the company. (The range of experts to speak with is explored in Chapter 8.)

Another method for assessing consensus expectations is to survey buy-side analysts. The level of formality can range from a web-based survey to simply calling five colleagues. There are a number of buy-side and sell-side analysts who survey buy-side analysts weekly or monthly to gauge what’s in consensus in terms of the key assumptions, as well as to assess investor sentiment.

If an analyst has an out-of-consensus estimate, it’s important to avoid a common rookie mistake of putting undue faith in companies that have a weak management team, poor track record of achieving success, or unproven success. Henry McVey, a former Morgan Stanley strategist, liked to say, “Avoid the blowups.” This may sound like common sense, but it’s alarming how many analysts, especially those early in their careers, assume their financial forecast is better than the Street, just because it puts more faith in questionable stories. The more experienced sell-side analysts that make up consensus often give a haircut to their financial forecasts for poorly performing or unproven companies. So, discovering your estimate is well above consensus may not be cause to upgrade a stock. Viewed another way: When faced with questionable stories, swing for singles and doubles, rather than trying to be the home-run hero, especially if you are an analyst early in your career.

Many buy-side analysts don’t have the time (or possibly the desire) to develop their own financial forecasts, and instead rely on sell-side analyst’s forecasts. For those who follow this strategy, the first goal should be to determine which analysts are the most accurate. This

isn't to say that only sell-side analysts with accurate earnings can add value to the buy-side, but rather that buy-side analysts should make sure any analyst they use for financial forecasting has a proven record in this area. This can be done more efficiently through analyst accuracy polls provided by StarMine, Bloomberg, and FactSet. Here are some of the facts to back up this view:

- A well-established study showed that stock recommendations from sell-side analysts who are in the top quintile of *earnings-forecast* accuracy generate almost 75-basis-points-higher returns than a passive index, whereas recommendations from those in the bottom quintile underperform a passive index by over 50 basis points (Loh and Mian, 2006).
- Another study shows that price targets set by *Institutional Investor's* "All American" analysts are achieved 54 percent of the time within 12 months of applying the target (Asquith, Mikhail, & Au et al., 2005). When they exceed the target, they do so by 37 percent.

Buy-side analysts who create their own forecasts without the help of the sell-side may have a reason to share them with the sell-side, but only at the right time. If after thorough, intelligent work, a buy-side analyst discovers that he's found a reason to be out of consensus and his firm has put on the trade, it's perfectly within his right to influence sell-side analysts to understand his perspective so that consensus (and presumably the stock) moves in his direction. This can be through e-mail exchanges and one-on-one dialogue with sell-side analysts.

Valuation Superior to the Market

Developing an out-of-consensus stock recommendation based solely on expectations that a stock's valuation multiple will be rerated or that the market will change its preferred valuation methodology is

plausible, but too often used unsuccessfully by inexperienced analysts. Forecasting that a stock's current 15 times P/E ratio is going to 17 times with no clear catalyst should be met with skepticism. Multiples tend to move in the direction of financial forecast revisions (discussed earlier), which isn't the same as the concept of generating alpha by correctly forecasting that the market will afford a stock a new multiple or valuation method. For example, in 2008, telecom analysts were split, with some valuing stocks on EBITDA, while others were defensively using dividend yields. However, the real valuation differentiator should have been focused on their financial forecasts, specifically, each company's ability to refinance its debt.

If an analyst is going to use an out-of-consensus valuation multiple or methodology as the rationale for a stock call, there must be a clear understanding about *why the market has this misperception and the catalyst that will correct it*. Conducting historical valuation analysis for established companies or comparing multiples of other companies with similar expected growth rates should help frame the analysis (as discussed in more detail in Chapter 19).

Let's first discuss potential changes in *valuation methodologies* as a catalyst for stock recommendations, as it's a relatively straight-forward concept. As a general rule, the preferred methodology for valuing a stock doesn't change much over time. There are three primary exceptions to consider:

- When the company or sector is going through a major *secular* transformation, such as moving from subpar returns to generating returns well above the cost of capital, or when a growth sector hits a wall because its market has become saturated.
- When the company or sector is at a certain point of the business cycle (e.g., a time of major distress) that leads the market to use a floor valuation, such as price-to-book (P/B) ratio, price-to-sales (P/S) ratio, or dividend yield.

- When the sector goes through changes in accounting (e.g., media companies transitioned from EV/EBITDA ratios to P/E ratios when accounting for amortization went away).

Given that these situations are not routine, often only occurring once in a decade for any given sector, they shouldn't be the basis for many stock calls. As an analyst with extensive sell-side and buy-side experience put it, "Don't change your valuation methodology just because the stock is moving. Do so only if there's a major change to fundamentals." Great calls can be made here, but only if the analyst can accurately predict the impact of one of the major events mentioned above (which is difficult to do, even for experienced analysts).

Discounted cash flow (DCF) is arguably the most complicated among the more commonly used valuation methods and is also favored more in academia than in practice. It's for this reason that new analysts, fresh out of business school, will often fall into the trap of assuming their intricate DCF valuation has found a mispriced stock that the market has missed using its more traditional multiples-based methodologies. This alternative valuation method is helpful in thinking through the long-term drivers to value creation, but it shouldn't be used as the basis for a stock recommendation unless the rest of the market is going to convert to DCF analysis during the typical investment time horizon. In general, don't assume that just because a valuation methodology is more complex, it will correctly forecast a superior price target.

The other area where an analyst can have an out-of-consensus view on valuation is with the multiple, which is more feasible than a change in valuation methodology, because it tends to occur more often. With that said, it is also often misused in poorly constructed stock calls. We use the term *multiple* to refer to the typical valuation multiples, such as P/E and price-to-free cash flow (P/FCF), but also for the assumptions that drive DCF and residual income models.

A common mistake made by inexperienced analysts is to say that a stock's multiple looks cheap without thoroughly reviewing the forecast. For example, if a stock is trading at a 9 times forward consensus estimate compared with its historical 10 times (10 percent below normal), it could be because the consensus estimate is stale and almost certain to head 10 percent lower, which the market may have already discounted in the stock price. So the analyst makes a big call only to discover her estimate (and consensus) needs to be lowered over the following three months, putting her stock multiple right back to where it belongs. *Before an analyst recommends a stock based on a change in the stock's multiple, the financial forecast should be rigorously tested to ensure that it's not likely to soon move in the wrong direction.*

When a company is going through a transformation, such as a major turnaround, there is a justifiable reason to assume that the multiple will expand. But the market isn't likely to pay the higher multiple until earnings start to beat consensus. Recall that having a well-researched, out-of-consensus financial forecast provides a more stable platform for recommending a stock.

Another common mistake in this area is to disregard the current place of the economic or sector's cycle. Cyclical stocks often trade at trough multiples at the peak of the cycle and peak multiples at the trough. When the market concludes that the peak is about to occur, multiples will contract and no well-constructed stock recommendation is going to stop the freight train until the market concludes that down leg is no longer imminent. That isn't to say an analyst shouldn't try to call the end or beginning of the cycle before the market, but fighting the tape in the face of a potential inflection point is usually a losing proposition. *Before an analyst recommends a cyclical stock based on a change in the multiple, an understanding of where the company is in the sector's or economic cycle must be thoroughly appreciated.* This can (and should) be explored by conducting a historical review of valuation multiples compared with the economic and sector factors discussed earlier. For cyclical stocks, when late into the business cycle, compute multiples based on normalized earnings and cash flows to see if they are truly "cheap."