AnalystSolutions

Best Practices for Equity Research Analysts

Supplemental Handout

February 2012

Acknowledgements

Some of the content has been adapted from *Best Practices for Equity Research Analysts,* authored by James J. Valentine, CFA and published by McGraw-Hill.

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Slide 1

Destroying >$1 Trillion Per Year

Service	Value-destruction (in Billions)
Long-only funds not generating alpha	$300
Wealth management not achieving benchmark returns	$250
Hedge funds falling short of target return	$51
Sell-side and credit rating agencies' inaccuracies	$459
Total	$1,060

Source: "Financial Markets 2020" study conducted by IBM as reported by the *Financial Times*, April 3, 2011

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Slide 2

A Dozen Challenges

1. Improving time management
2. Identifying the critical factors likely to drive a universe of stocks
3. Developing unique sources of content
4. Ensuring stock calls are differentiated from the consensus view
5. Communicating stock calls so they add value
6. Deriving insights from information sources
7. Forecasting where consensus is wrong
8. Understanding the strengths and weaknesses of popular valuation methods
9. Avoiding the most common psychological mistakes made by investors
10. Persuading others to act on stock recommendations
11. Making ethically-sound decisions
12. Self-assessing strengths and gaps compared to other analysts

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Activity, Evaluate Daily Activities

- Write down all of your activities during a typical work day.
- In the right-most columns, check if the activity is typically initiated by you (“I”) or is typically in response to information or requests you receive (“R”), such as an incoming email, phone call or taking a meeting requested by others.
- Include all activities from when you leave your home until you arrive back home.
- Do not turn to the next page until told to do so.

Daily Activities	I*	R*
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		
11.		
12.		
13.		
14.		
15.		

* “I” = you initiate, “R” = you are responding

Please do not turn to the next page until instructed

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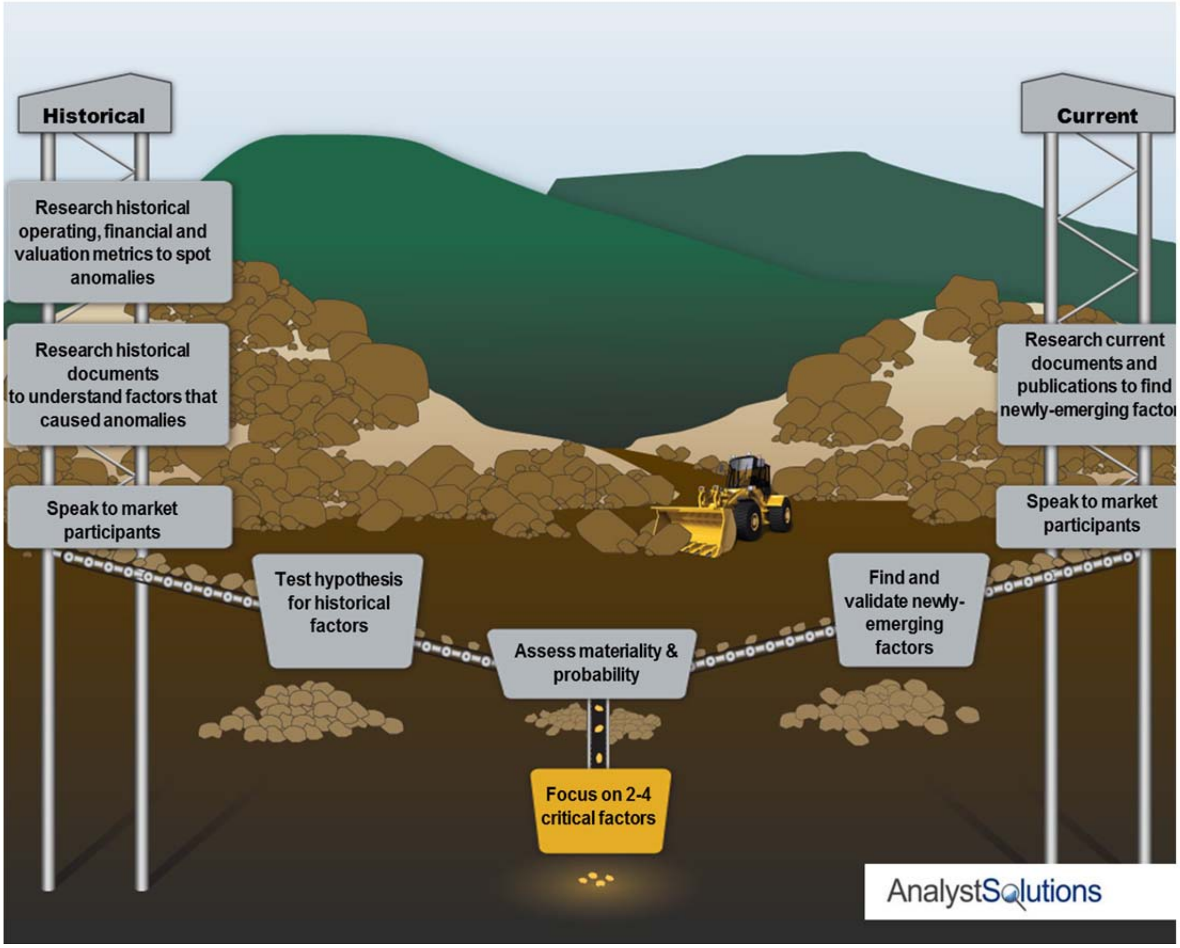
Instructions for AnalystSolutions' 4x4 Matrix:

- Review the matrix below
- Put the numbers from the prior page activities in the most appropriate box below

		Generates Differentiated Insights Useful for Stock Picking	
		LOW	HIGH
Initiating vs. Responding		Scan Public Info	Generate Alpha
	YOU INITIATE (Offense)		
	YOU RESPOND (Defense)		
		Waste of Time?	Surprise Find

Slide 3


Historical
Current
Research historical operating, financial and valuation metrics to spot anomalies
Research historical documents to understand factors that caused anomalies
Speak to market participants
Research current documents and publications to find newly-emerging factor
Speak to market participants
Test hypothesis for historical factors
Find and validate newly-emerging factors
Assess materiality & probability
Focus on 2-4 critical factors
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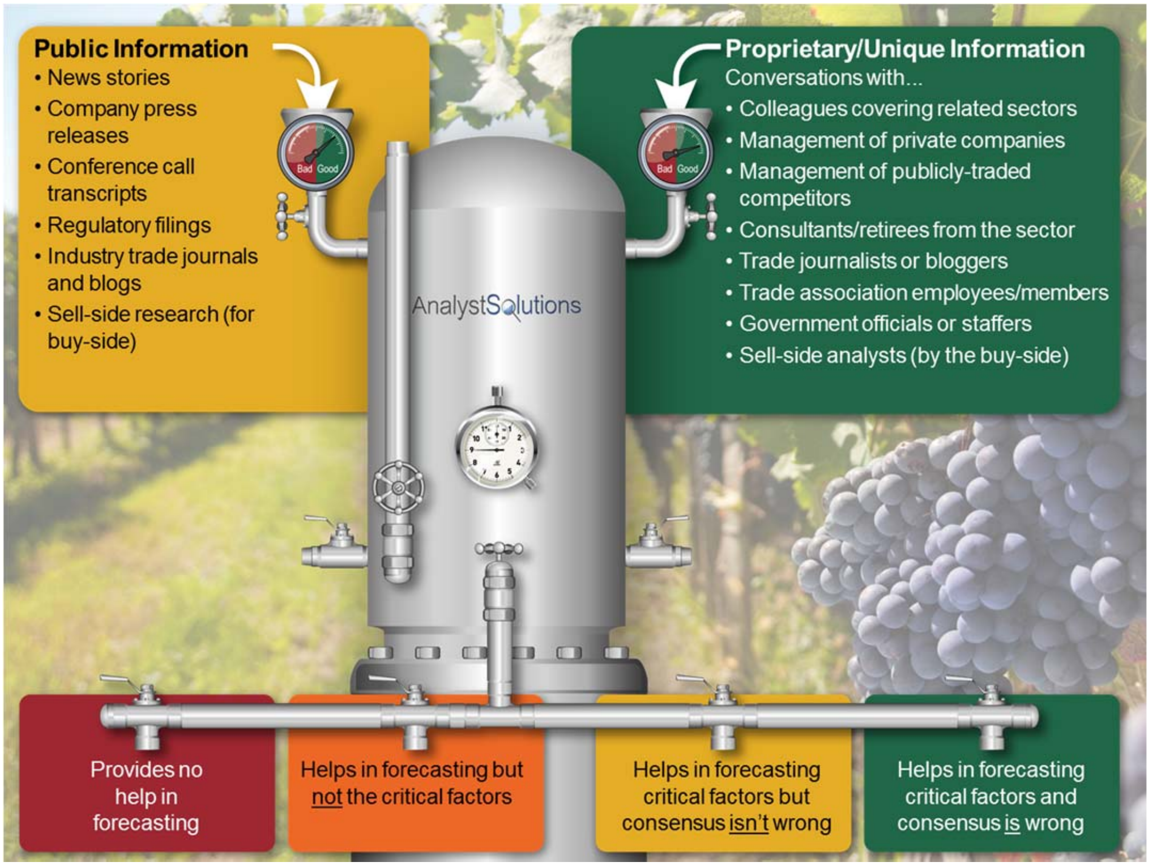
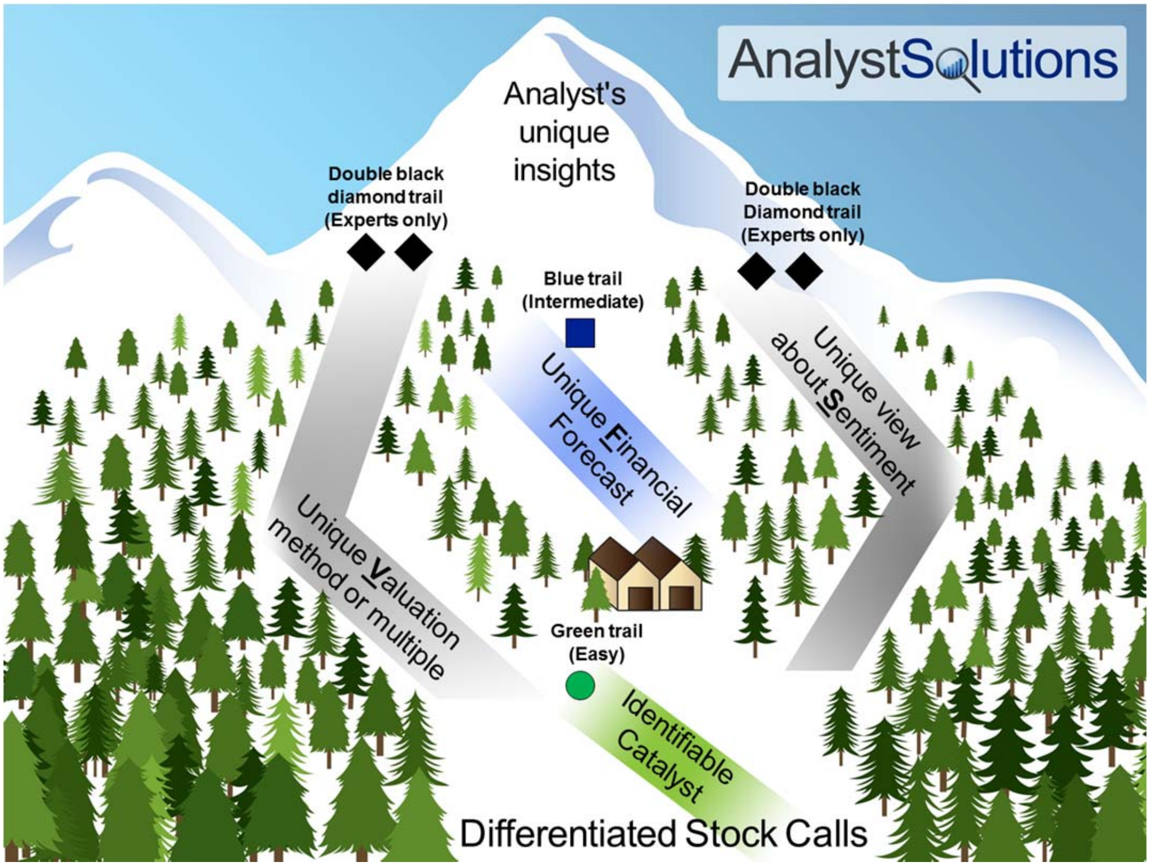
Creating Differentiated Product

Slide 4



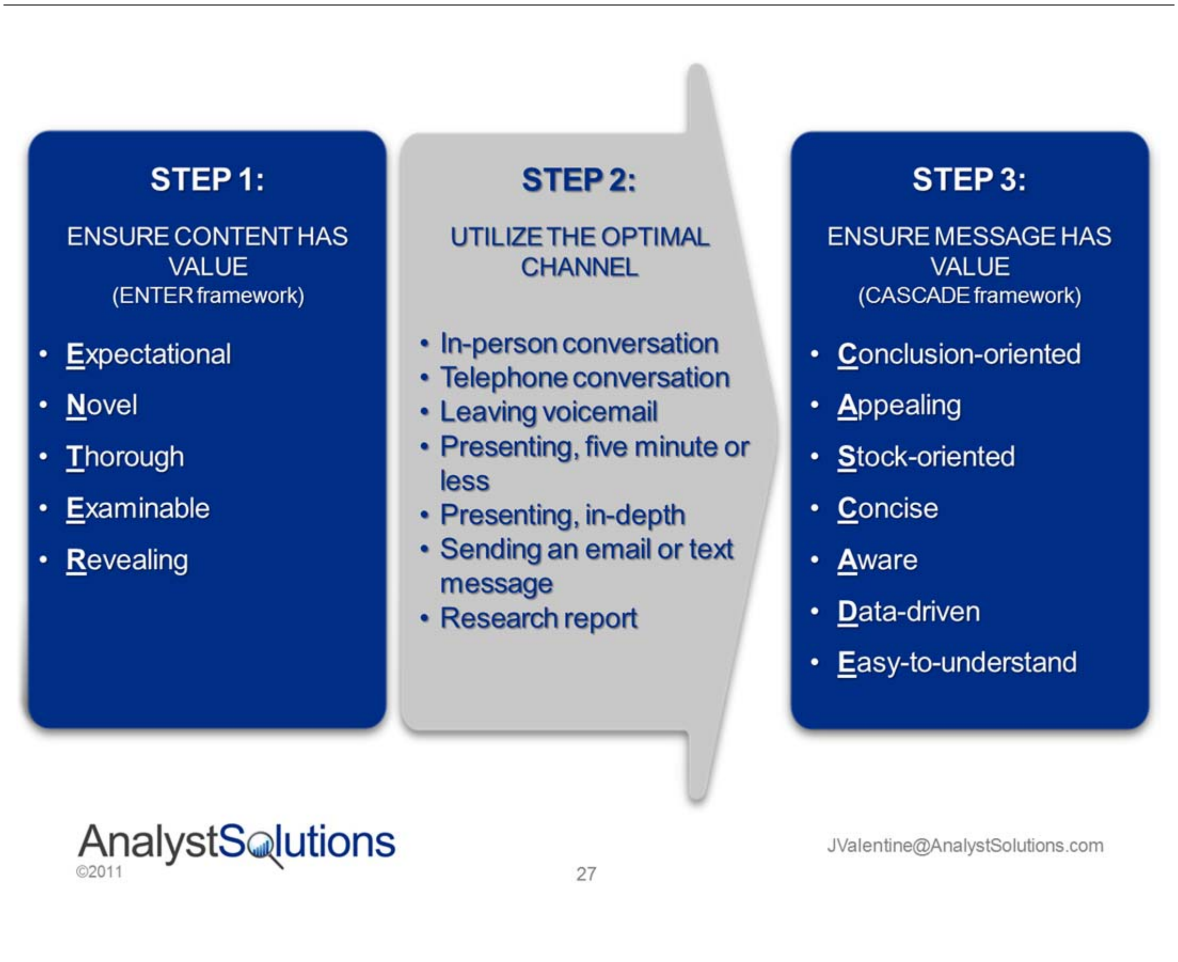
Creating Differentiated Product

Slide 5



Getting your message heard

Slide 6



Quick Reference Card (QRC): Best Practices for Time Management

Specific to research analysts:

- Maximize offensively-focused activities where proprietary insights are most likely to be found. Examples include:
  - Making outgoing phone calls to information sources who offer insights that improve forecast of critical factors
  - Participating in private or small group meetings with industry expert(s) or company management
  - Attending an industry conference where few financial analysts are in attendance
- Minimize defensively-focused activities such as those that may provide background but not alpha-generating insights. Examples include:
  - Quarterly earnings conference calls (reading the transcript can be done in half the time as listening to the call)
  - Reading regulatory filings (use services that highlight the information that has changed from the prior filing)
  - Sell-side-sponsored investor conferences (only attend if one-on-ones are available)
  - Site tour, especially when no senior management are present (if the tour doesn't cover a potential critical factor, spend time elsewhere)
- Apply the 80/20 rule
  - As a general rule, 80% of alpha-generating insights come from 20% (or less), of the available information flow – focus on the sources that traditionally yield insights
  - Proactively turn off as much of the 80% unproductive information flow in order to reduce the noise
- Plan travel intelligently:
  - Once the companies are understood, attend only the portion(s) of events that are likely to help identify or understand the critical factors
  - Leverage time on a trip by accomplishing more than one goal (meet with more than one company or information source when on the road)
  - Leverage technology and plan ahead to use time out of the office wisely; commuting and travel time can comprise 20% of the work week. Do more than just read the financial press
- During offensively-focused research time, send all calls to voicemail, shut

the door, or if in a common area put on headphones (or a headset) to make it clear to others that you don't want to be disturbed

- Screen all in-bound phone calls, only taking calls from those who have a proven track record of adding insight or are responding to your questions (they will leave a voicemail if it's important)
- Turn off pop-up e-mail and instant message alerts
- Unless in a trading environment, look at your stock screen only a few pre-planned times per day (e.g., upon arrival in the morning, at the open, lunch, and near the close)
- If a regular daily task is required to conduct research or communicate, but is of low value, consider delegating, automating, or outsourcing
- Periodically self-reflect to avoid burnout. Steps for avoiding burnout:
  - Strive to have balance between professional and personal life
  - Set a realistic timetable for achieving career goals
  - Make time for self-reflection and getting input from close friends. Ask:
    - Am I scheduling and enjoying activities outside of work?
    - Am I regularly in conflict between professional and personal goals?
    - Am I becoming annoyed with my job?
    - Do I genuinely celebrate personal and professional victories?
- Invest time to strategically set up an information hub to maximize insights and minimize noise (see Chapter 5 of *Best Practices for Equity Research Analysts* for more details)
- Don't spend time speaking to the press unless:
  - The journalist provides insights
  - Your ego badly needs gratification
  - It will improve your year-end review (which in most cases, it won't)

Buy-side only:

- Avoid attempting to read every sell-side report on every company and instead find the two to three analysts in each sector who are the best fit (Bloomberg, StarMine, and FactSet have features to identify sell-side analysts who are the best at forecasting earnings and stock picking). Only watch for ratings changes or other big think pieces from the rest of the sell-side.
- Unsubscribe from information services and analysts' distribution lists if they don't add value.
- Routinely remind sell-side salespeople of needs and how they can add value.

- Utilize sell-side or third-party financial models when it doesn't compromise accuracy or insights, such as (see Exhibit 17.2 of *Best Practices for Equity Research Analysts* for details):
  - Creating the model architecture in terms of what's important
  - Building historical data
  - Updating quarterly data

Sell-side only:

- Return all non-time-sensitive calls at one block of time during the day (e.g., from 2 to 4 p.m.), delegating some of the less important calls to a junior member of the team.
- Learn how to say "no" diplomatically (e.g., telling a salesperson you're not doing lunch with a small client).

General time management rules:

- Value your time
  - There is no such thing as free time; all time has value
  - If you're having trouble managing your time, keep a log for a while and evaluate it
- Use shortcuts
  - Increase your reading speed
  - Underline and/or highlight key concepts
  - Develop a note-taking system that can be quickly searched and cross referenced (see Chapter 5 of *Best Practices for Equity Research Analysts*)
- Plan your week in advance (it will never play out exactly as planned, but having no plan puts your valuable time at risk of being wasted.)
- Implement the prioritization skills taught in time management classes. (GTD and FranklinCovey are two of the better ones offered)
  - Concentrate on one thing at a time
  - Become a better listener

Sources:

General Rules: Lisa J. Downs, *The Time Management Process and Scheduling Time and Tasks*, American Society for Training and Development (ASTD); B. Eugene Griessman, Time Tactics of Very Successful People, McGraw-Hill, New York, 1994.

Specific to Research Analysts: James J. Valentine, CFA, *Best Practices for Equity Research Analysts*, McGraw-Hill, New York, 2011

Quick Reference Card (QRC):

Assessing and Approaching Information Sources

1. When seeking industry contacts, look for individuals who are *not* employed by the company being researched, because management is often biased and likely muzzled
2. Identify the following types of independent information sources (not management of the company being researched) that are close to the critical factors that drive your assigned sector(s) and stocks:
   - Fellow analysts within your firm who cover sectors that have influence over the critical factors impacting your sector(s)
   - Large customers and suppliers of the company being researched (e.g. suppliers can include union leaders who represent labor, which is often a large cost component for companies)
   - Management of competitors to the company being researched, especially those working for privately-held companies (because they're not held back by Reg FD)
   - Industry consultants
   - Retirees from companies in the same sector
   - Experienced industry journalists and bloggers
   - Forecasting service
   - Trade association employees and members
   - Individuals who have a cross-sectional view of the sector such as employees who record applications or process transactions for the sector
   - Government officials or staffers who are close to the sector
   - Sell-side analysts (for buy-side analysts) and buy-side analysts (for sell-side analysts)
   - Financial journalists if they focus on a limited number of sectors
3. As you're reading industry trade journals or news stories specific to your industry, record the names of individuals who meet the criteria above (I found that if someone was willing to be quoted in a news story and didn't work for a public company, they were usually willing to speak to a financial analyst)
4. Seek contacts in target rich locations. Preferably, find individuals who already have their own network such as journalists and consultants:
   - Trade associations
   - Lobbyists
   - Social networking groups such as LinkedIn
   - Industry journals (journalists and the experts who are quoted) or bloggers

- Alumni networks
- Industry conferences and trade shows (request an advanced list of attendees to set up meetings with before the event or survey them afterwards)
- Industry task forces and committees
- Contacts of other analysts in your firm (ask before calling them)

5. Look for contacts every chance you get because you never know when you might need someone's insights (have business cards wherever you go, even on vacation)
6. Before approaching potential contacts, answer the critical question, "What's in it for them?" Potential ways to compensate your contacts (other than financially) include:
   - Respond to their sector or company questions that you're qualified to answer, such as why a stock is priced where it is
   - Access to your research (if you publish) or your firm's research
   - Recognition such as asking the contact to speak at a conference, to your firm's investment committee (via conference call), or referring the press to the contact
   - Access to other industry experts such as through a dinner or round table discussion (with or without other analysts in attendance)
7. Ensure that you've done enough preliminary research on the topic to be credible and have a worthwhile discussion. The best industry experts usually enjoy high-end discussions and tire quickly when explaining the sector basics
8. Conduct research on contacts in advance of speaking with them (e.g., Google, LinkedIn, ZoomInfo, Bloomberg).
9. When you've made a personal connection with an industry contact, determine quickly how this individual's expertise can help forecast critical factors. If it becomes clear that the contact doesn't have expertise, see if he has connections to those who can help. If not, be polite by thanking the contact for his time and move on to the next contact.
10. When a contact responds to your request, immediately put her in your contact database; you'll be glad you did when you need her information in the future
11. When you discover a significant piece of information, attempt to verify with at least one other proprietary source, especially if it's critical to your investment thesis

Quick Reference Card (QRC): Ensuring Success as a Stock Picker

- Appreciate that stock picking is challenging because:
  - All of the information needed to make a perfect stock call is rarely available.
  - As an analyst diligently takes more time to dig deeply into solving an investment controversy, the early stages of research often become known by the market, thus diminishing the value of the work.
  - There may not be any substantially under- or over-valued stocks within an analyst's universe at a given point in time.
  - Some factors that move stocks cannot be forecast.
  - Many analysts are asked to cover too many stocks which prevents them from developing the differentiated insights required for a successful stock all.
  - Emotions cloud clear thinking, often causing an analyst to make the wrong decision (see Chapter 21 of *Best Practices for Equity Research Analysts* for more details)
- For a stock call to generate alpha, the analyst must have differentiated insights superior to the market in at least one of the areas below (the FaVeS framework discussed in Chapter 20 of *Best Practices for Equity Research Analysts*). If none exist (or they do not differ much from the consensus thinking), then there is no stock call to be made:
  - <u>F</u>orecast of financial results, such as EPS or cash flow.
  - <u>V</u>aluation multiple or methodology.
  - <u>S</u>entiment of the market toward the stock.
- <u>F</u>orecasts
  - When an analyst's forecast is out of consensus, additional work should be done to determine if the consensus is more accurate. This is done by:
    - Ensuring consensus includes many sell-side estimates and is not isolated to just a few who happen to have forecasts for the time period being used.
    - Comparing the informed consensus of the most accurate sell-side analysts with the overall consensus.
    - Ensuring the individual sell-side estimates are not stale and there is no disagreement in terms of special items that may be in the number.
  - If after this work, an analyst's estimate is still out of consensus, it's critical to speak with market participants, such as portfolio managers, buy-side analysts, sell-side analysts, and company management, to understand why. Some buy-side and sell-side analysts conduct informal surveys of the buy-side on a weekly or monthly basis to ensure that they have their hands on the pulse of consensus expectations.
  - Analysts should avoid a common rookie mistake of having forecasts higher than consensus, simply based on greater faith in an unproven or weak management

team.

– Buy-side analysts who use sell-side analysts for financial forecasting should check with third-party services to ensure that the ones they use have a good track record of high forecast accuracy.

– If a buy-side analyst is using a proprietary financial forecast and has put on the trade based on the forecast, it is often helpful to inform the most influential sell-side analysts so that consensus (and the stock price) comes around to the buy-side analyst's thesis.

- Valuation

  – Be hesitant to make an out-of-consensus stock recommendation based solely on the expectation that a stock's valuation multiple will be rerated or that the market will change its preferred valuation methodology, because these situations do not often occur without the benefit of a change in the financial forecast first. Changes to valuation methodologies tend to occur only when companies or sectors:

    - Are going through a major secular transformation
    - Are at a peak or trough of the business cycle
    - Are converting to a new accounting method

  – When using an out-of-consensus valuation multiple as the basis for a stock recommendation, ensure that:

    - The company or comparable companies have been afforded this multiple under similar conditions in the past. Avoid using the average historical relative multiple of the past, without considering changes that have taken place in the company's prospective growth rate and risk characteristics.
    - For growth companies, ensure that the multiple isn't out of line with companies in other sectors with similar growth prospects and risk profiles.
    - When possible, the multiple(s) should be shared with a trusted colleague or investment committee, so as to avoid personal biases from self-selecting a particular multiple.

- Sentiment

  – Exploit flaws in market sentiment to enhance stock picking as highlighted in Exhibit 20.1 of *Best Practices for Equity Research Analysts*.

  – Monitor factors that help to understand market sentiment as highlighted in Exhibit 20.2 of *Best Practices for Equity Research Analysts*.

- Before making a new stock recommendation, ensure there is a catalyst that meets these criteria:

  – Pertains to a critical factor that's material enough to move the stock

  - Not currently appreciated by the market
  - Can be forecast with some level of certainty
  - Likely to occur during the investment time horizon

- Proactively put dates in the calendar for the following types of events with the expectation that catalysts will likely move stocks:
  - Company-sponsored analyst meetings and calls
  - Earnings releases
  - The company's annual pricing, volume, or earnings guidance or projection
  - Deadlines for new legislation, regulations, or court case outcomes
  - Prescheduled announcements by the company's customers, competitors, or suppliers
  - New product releases or significant product extensions
  - Interim sales data, for the company or the sector
- Before making a stock recommendation, answer these questions:
  - What unique insight isn't in consensus?
  - Why doesn't consensus have this insight, or why is consensus ignoring it?
  - What is the catalyst that will get the market to accept this out-of consensus view, and when will it occur?
  - What could go wrong?
- Individuals who can help answer these questions above include:
  - Experienced buy-side analysts or PMs who currently own or have owned the stock in the fund
  - Sell-side salespeople who have interest in the stock
  - Sell-side traders who trade the stock
  - The company's investor relations contact
  - Sell-side analysts (for buy-side analysts)
- Attempt to convey the level of conviction associated with each stock call, as it will help portfolio managers and clients better assess the call.
- When setting price targets, attempt to set a range of targets rather than a single-point estimate.
- Adjust price target multiples when:

  - The multiples of comparable companies change
  - Time passes, causing new forward multiples to change
  - The multiples of multi-period cash flow models change (such as the risk-free rate and equity risk premium)

- Understand the factors that have historically caused investors to rotate into or out of the assigned universe of stocks in order to help the challenging task of identifying them in the future
- Set a range of exit thresholds in advance of making a stock recommendation, because it will prevent biases from creeping into the decision at a later date, which occurs all too often
- If new information comes to light that derails the basis of a stock call, validate the information, and if it's likely to hold the stock back, do an about-face on the rating as soon as possible
- Review valuation levels of the assigned universe of stocks regularly, preferably on a daily basis, but no less frequently than once per week