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Equity Analysis Issues, Lessons, and Techniques

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Overview: An Opportunity to Add Value

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Equity research and valuation is not a new topic. It has been widely practiced for many years (perhaps with the exception of 1972 and 1999). What is new is that the equity market is starting to be less efficient, and as a result, investors will have greater opportunities to add value with rigorous fundamental research and disciplined valuation methods.

Pockets of Inefficiency

For various reasons, which I will discuss in this section, the market now contains more pockets of inefficiency that are appearing with greater frequency and that investors can exploit—if they know where and how to look.

Indexing. Indexing is not going to disappear and might be increasing. It is a cost-effective way for investors to produce low tracking error and good information ratios and to be guaranteed they will never outperform, which is a strange set of objectives. That said, some people find these goals attractive for all or part of their asset mix. Indexing is a form of momentum investing. It assures investors that they will always own the extremes (the extremes at the high end and the low end). As the indexing trend continues, it will exacerbate those extremes and, because markets tend to mean revert, present managers with opportunities to add value by exploiting such extremes.

Concentration of Assets. The concentration of assets, both by asset managers and investors, is a significant change that creates more opportunities to add value. The money management community is obviously consolidating, and as the consolidation occurs, liquidity becomes a major obstacle. That liquidity barrier creates opportunities in the mid- to small-cap sector of the market for those who can effectively manage around the liquidity issue and take advantage of it. This opportunity is not new, but it is becoming a bigger factor for active managers.

A more subtle dimension is the fact that investors' assets are becoming more and more concentrated. The rise of 401(k) plans is an enormous North American phenomenon that is concentrating assets in the hands of individuals who tend to be less structured, more emotional, and unfortunately act like the wildebeest: They follow trends. In 1999, they plodded into stock funds that were heavily invested in high tech, and now, they are chasing bond funds that have been on the rise for some time. This behavior is having two impacts. First, it is another pressure to extend extremes (momentum investing) and add to the emotional volatility of the market. Second, and more subtly, it is forcing managers to follow those trends even more so than in the past. That is, mutual fund managers are paid for the assets in the portfolio as well as the performance of the fund. If they do not stay with the momentum, they will lose assets and they will lose income. The result is they have a strong incentive to extend trends. Another impact is that it discourages mutual fund managers from being style purists and staying the course when their style is out of phase. This style shifting creates a great opportunity for managers who can resist this pressure and add value by staying with their style at such times. But it requires a more sophisticated client base that is willing to accept these out-of-phase patterns to gain higher long-term returns.

Regulation FD. Corporations and money managers are adjusting to the challenges of Regulation Fair Disclosure (FD), but it has created more opportunities. The money management side has always dealt with inside information and materiality, although, unfortunately, not always too well. Corporations, however, have been given the new responsibility of trying to determine what is "material" to investors. As the Regulation FD issue is evolving, investors are being presented with either too much data (data dump) or too little data. New opportunities are available for managers who can adjust rapidly and find the critical information to make good investment decisions.

Hedge Funds. Some people naively refer to hedge funds as an asset class, which implies that they are a homogeneous group. Clearly, this notion is wrong. Hedge funds can range from long–short to leveraged currency trades, and their impact on market efficiency is just as wide. I believe the long–short strategies are likely to make the market more efficient; however, the high-specific-risk strategies create

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opportunities. These strategies exacerbate trends and increase volatility, which again creates an opportunity for stock pickers who can look beyond the short-term impacts of such hedge fund activities.

Wall Street Contraction and Analyst Independence. This issue is probably the most significant change in our industry and one that is creating opportunities for value-added investing. It is a secular and cyclical set of changes. Sell-side research and investment banking have effectively, and hopefully permanently, been separated. As a result, we have more objectivity; moreover, we have changed the process and the economics of research. The research analyst's efforts are now being scrutinized more closely by internal and external observers, and that added scrutiny has slowed sell-side analysts' processes and ability to deliver timely and effective research.

An analyst now has a more burdensome environment in which to operate. He or she may actually have less information because of the separation and because of Regulation FD. In addition, the rules about and latitude surrounding what and when the analyst can publish have likely hindered the ability to produce value-added research.

One of the biggest changes in our industry is the economics of traditional research as a result of this separation from investment banking. It is much like May Day in 1975 when commissions became negotiable: The rules have changed, and so has the way research is sold. A large sell-side house might have a research department that costs $500 million a year, and it can no longer be "directly" subsidized by investment banking. That change has created an economic unit that may very well be a cost center . . . not something that can last long. The sell side is in the process of deciding how to make the economics of a research department work when the only source of income is the 3–6 cents a share commission. To make matters worse, this change comes at a time when our industry is in a cyclical contraction. The result is that there are perhaps 30 percent fewer sell-side analysts, and because of the change in process and Regulation FD, their ability to follow companies has been reduced by 30–40 percent as well. In addition, because of less robust economics, they have a smaller research budget, a smaller staff, and a smaller travel budget at a time when there is actually more work to be done.

Now, look at the income side of the equation. The current source of income is per share commissions. Where are the high-volume shares? They are in large-cap companies, the most efficient sector of the market. A residual of this effect is that analysts are forced to reduce coverage in the mid- to small-cap sector—the most inefficient sector. This situation creates a terrific opportunity for those who are able to focus their research *and* invest cost-effectively in this sector.

Hedge funds are another major source of commissions because of their high turnover. Some people estimate that hedge funds now represent 35+ percent of trading volume, with higher levels in certain industries. Despite the attractiveness of their volume, they represent yet another potential distraction for the analyst. Normally, hedge funds' time horizon is significantly shorter, which may cause analysts to adjust their horizon and perspectives as well. This change, in turn, may give rise to market inefficiencies and opportunities.

One last aspect of industry contraction is the analyst's "new" role. Clearly, the change in economics is a factor affecting analysts, but beyond this factor is the change in professional challenges. Analysts who were doing the IPOs, the investment banking deals with all the lights and glitz, may not like their new role, which is more traditional—analyzing companies and 10-Qs and doing gumshoe work. For some analysts, this change is welcomed. For others, this new role may not be as rewarding and profitable; the seven-figure-salary analyst may be history. Consequently, many seasoned analysts are leaving the business. Many are now running hedge funds, where they can use their concentrated knowledge and focus on a narrow niche. Thus, the job is changing and the people are changing, which is creating opportunities for managers to conduct research.

Consequences of Inefficiency

Bottom line: The Street's ability to add value has been reduced, and this change increases the opportunities for those who conduct rigorous fundamental research and disciplined valuation methods. Someone smart will solve the sell-side problem, and as a result, that person will be rewarded handsomely. In the interim, however, the market will have more pockets of inefficiency that show up more frequently and opportunities will be greater.

Money managers must examine how dependent they have been on Wall Street research and how they will respond to these changes. If a firm's main source of research has typically been from the sell side, the firm has a short-term problem. The basic business decision of build or buy is at hand for many. This decision will not be easy because building research is expensive.

For those who decide to conduct their own research, they must look at more than just the quantitative side of companies. The analysis must also include the qualitative side—the corporate culture, management, and governance.

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Application of Issues, Lessons, and Techniques

Keep in mind that none of these aforementioned recommendations are all that new; they are techniques that most investors learned about years ago. And some investors have indeed been applying these techniques for years. **John Neff**, in particular, has been using his own version of these techniques, low-P/E investing, for more than 30 years. In his presentation, which was a session in which I interviewed him, he reveals his thoughts on how to decide when to buy (and sell) a stock, the value of stock picking in today's market, and general trends in the industry.

Remarkably, most of these fundamental equity analysis techniques can be traced back to Benjamin Graham. Although Graham is no longer around for us to ask him questions, **Jason Zweig** recently edited Graham's *The Intelligent Investor*, and as Zweig describes in his presentation, he learned a great deal about Graham's thought process.[1] Zweig relates the things that made Graham famous, the factors that caused his reputation to drop out of fashion, the insights that make him relevant today, and the many ways in which he showed himself to be a man of brilliance. Equity analysts and investors cannot afford to bypass the wisdom of such a sage.

In the 50 odd years that have passed since Graham first wrote *The Intelligent Investor*, accounting rules have certainly changed. Graham was a visionary, but I am not sure if even Graham could have envisioned the potential convergence of U.S. GAAP and International Accounting Standards by 2007. **Patricia McConnell** describes the upcoming changes in her presentation and emphasizes the Financial Accounting Standards Board's (FASB's) projects on accounting for stock compensation, business combinations, and revenue recognition. Clearly, accounting changes affect a company's financial statements, which affect how well investors can analyze that company, but McConnell also emphasizes that investors and analysts should not be passive observers of these changes. While the FASB is still seeking comment on the accounting changes, investors and analysts should actively make their opinions known. Otherwise, the results may not be to their liking.

Just like the saying "everything old is new again," quality of earnings has become important again. In the late 1990s, in the momentum phase of the market, investors did not care much about quality of earnings. But the importance of quality of earnings has resurfaced. **Catherine Schrand** discusses quality of earnings in her presentation and makes the distinction that earnings must be both reliable and relevant to be useful. She relates how unbiased estimation errors and purposeful earnings manipulation serve to degrade the usefulness of earnings figures. And even for companies with the best of intentions, U.S. GAAP applied to certain types of operations or transactions can create a low-quality earnings number. Thus, investors and analysts need to be especially vigilant in considering quality of earnings.

Earnings, however, are certainly not the only item that analysts and investors need to key in on. In the late 1990s, I remember being at a conference and telling the participants that they had to watch out for pension *income*. Now, market participants are focused on pension *expense*. Some of these companies have gone from having 75 cents a share in pension income to 50 cents a share in pension expense, which is a huge swing. Without a doubt, such a swing affects the value of the company. **David Blitzer** focuses his presentation on how a company should handle its pension plan because its actions affect not only the plan itself but also the company as a whole. That is, understanding pension accounting and how plans manage their assets can shed some light on pension accounting "gimmicks" and thus aid investors as they value these companies.

I mentioned earlier that equity analysis means more than just looking at numbers. It also means understanding a company's corporate governance. **Beth Young** tackles this issue head on. In her presentation, she explains that corporate governance practices should be viewed as a risk factor and handled accordingly by investors and investment managers. Toward that end, Young delves into the roles of traditional key players in corporate governance: boards, management, and shareholders. And to show the difference between good and not-so-good corporate governance practices, she analyzes the audit committee reports of two companies. Corporate governance should thus be of concern not just to large institutional investors, such as CalPERS (California Public Employees' Retirement System), but to all investors as they carry out their valuation process.

The culmination of all this research and analysis is identifying attractive stock opportunities, and what should be clear by now is that various accounting issues ultimately affect this identification process. But what happens in a global context where not only accounting rules but also taxes and

[1] Benjamin Graham, *The Intelligent Investor*, rev. ed., updated with new commentary by Jason Zweig (New York: HarperBusiness, 2003).

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local economies vary? In his presentation, **Andrew Williams** discusses the challenges international investors face. He makes the case that international equity investing is an area where active managers can add value. Williams then outlines three traditional approaches for identifying attractively priced stocks: global sector analysis, cash flow analysis, and local market and sector analysis. His research and practical experience show that the greatest benefit appears to come from using a multifactor sector and country approach largely because it eliminates accounting variations among countries. In essence, Williams' approach has allowed him to select stocks successfully on a global basis.

Conclusion

Because of pockets of inefficiency in U.S. equity markets, and perhaps global equity markets, "stock picking is still alive and well," as John Neff stated in his presentation. Investors and managers may have to look harder for these attractive stocks, but opportunity still exists to add value. As the authors in this proceedings point out, the techniques investors and analysts should be using are not new; rather, the methodology boils down to fundamental analysis (perhaps with a slight twist here and there), something that I think would make Benjamin Graham smile if he were alive today.

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