## The Importance of Securities Analysts

***How to use analyst recommendations and forecasts***

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The amount of information available to traders has exploded in recent years. Dedicated financial news channels on TV, business magazines, newspapers, Internet websites, corporate filings and press releases provide a lot for individual investors to sift through. But quantity is not the same as quality.

It has never been harder for investors to decide which information they should trust. As a result, many investors rely too heavily on the recommendations of analysts.

Securities analysts have always been among the most important people on Wall Street, and are a useful source of information for both institutional and individual investors. Their reports and recommendations are closely followed and are play an influential role in many investment decisions. Following the release of analysis reports, trading volumes surge and stock prices react almost immediately. But it is important that you understand the context in which analyst recommendations are generated, and the ways in which they should be used.

From the point of view of an economist, analysts allow capital markets to operate more efficiently. By doing in-depth research for their large institutional clients and employers, they allow capital to be directed to the most productive uses in our economy. Having analysts follow a company ensures wide investor recognition and increases its stock valuation.

In theory, analyst reports should be highly objective. But after the recent settlement with the large brokerage firms, few investors probably believe that any more. In a few of the worst cases, analysts have been accused of favoring companies who are clients of their institutions. They were pressured to provide good recommendations, and in return the investment banking divisions were chosen for work that resulted in lucrative underwriting fees. Making the clients happy helped analysts keep their jobs and boosted their compensation.

In a recent settlement 10 brokerage firms agreed to pay fines totaling $900 million to resolve charges that investment-banking considerations improperly influenced analysts' views. The settlement does not prove that analysts are corrupt, or even biased. But because analysts are called upon to make so many judgments that are not black and white, they can be vulnerable to pressure. That can affect their objectivity — no matter how honest or competent they may be.

Under the agreement, the brokers have also agreed to spend $450 million over the next five years for independent research by unaffiliated analysts. That means every time you get a brokerage analyst's research on a stock, you'll also receive a report on that stock from an independent research firm. The independent research will also be available on brokers' Web sites.

Long before all this became headlines in the business press, research had shown that certain biases existed among securities analysts, and sophisticated investors were already well aware that these biases existed, and often exploited them to their advantage. The reason understanding the biases of analysts is important is that they can actually affect the accuracy of earnings estimates and the associated valuations of the companies.

This then implies that an analyst's affiliation can have a considerable influence on future returns. Since the earnings forecasts of affiliated analysts tend to be more optimistic, and "buy" recommendations more frequent, those recommendations can "prop up" lagging performers in the short term. However when they don't produce results, those firms will then tend to under-perform over the long term.

A "buy" recommendation from independent or unaffiliated analysts has the opposite effect. Since they are perceived as more credible, the positive short-term return increases, and those companies also tend to turn in positive long-term performances (some research has indicated it could be 50% higher than firms recommended by affiliated analysts).

So every "Buy" recommendation should be examined for analyst affiliation, and then look for confirmation from an independent analyst. This only applies to “Buy” recommendations. In the case of a "sell" recommendation or a downgrade, both affiliated and independent analysts are considered equally credible.

That leads us to yet another problem. Analysts usually summarize their research reports with a brief recommendation, and every firm uses its own rating system. The same term might mean one thing for one firm and something else for another firm. One firm's "Underperform" might mean it expects a stock to appreciate 5% slower than the overall market over 18-months. For another firm, the same term might mean that it expects the stock to drop 10% within 12-months. Even providers of "consensus" ratings, such as First Call, use their own rating scales.

One of the main areas investors rely on analyst for are earnings estimates. I always look at just how wide a variation there is between different analysts. A tight grouping of estimates is good. There is a definite link between the degree of uncertainty of an earnings forecast and the reports of both affiliated and independent analysts. When uncertainty is low, analysts tend to undervalue the stock. In the short term prices are depressed, only to surge with the first earnings surprise.

On the other side, when the degree of uncertainty about earnings forecasts is high, all analysts tend to make over-optimistic forecasts. Those stocks then are overvalued in the short term, but later collapse as soon as the first earnings disappointment occurs. The tech sector is an area where such over-optimism tends to be common. Forecasting tech earnings is difficult and highly uncertain. So these stocks tend to be highly valued, until the first earnings disappointment, when they crash. What investor has not noticed (and maybe been burned by) this tendency?

Investors should look at the forecast uncertainty before taking action. If it is high, any purchase should only be for the short term and dumped before the next earnings release. If uncertainty is low, shares may be purchased with limited risk. Assessing uncertainty is relatively straightforward. It can be assessed by looking at the variation (or spread) of earnings forecasts reported by First Call or any of the other earnings reporting services. If the variation in forecasts is wide, uncertainty is high. If the variation is narrow, uncertainty is low.

Summing it all up, a smart investor can gain an advantage by "reading beyond the lines" of securities analyst's reports and recommendations. First, check the affiliation. Reports issued by affiliated analysts should be discounted, while those of independent analysts may be given more credibility. Second, focusing on the independent analyst's position, check the degree of earnings forecast uncertainty. If it is low, expect the stock to be undervalued and a long term candidate for appreciation. If uncertainty is high, expect a short term overvaluation followed by a crash.

The new agreement to include independent research is likely to a minimal or even negative, effect on the industry. The quality of research from the full-service brokers may suffer as they cut back on their own staffs, and those left become more guarded in their public pronouncements. The slack is unlikely to be taken up by the independents. Most of that independent research that will be supplied is sure to come from the large independent advisory firms, whose ratings are already available to the public. And independent analysts have the disadvantage of covering 30 or more firms, many more than is common for securities analysts in large investment firms.

The important thing to remember is that you should never rely solely on an analyst recommendation when making an investment decision. As in any other field, not every analyst can be the best. To learn about different analysts' track records, you can either follow their recommendations over time, or refer to rankings that are found in some magazines, newsletters, and Internet Web sites.

There are many other important sources of information and factors you should consider than just what an analyst says. In other words, do your own investment homework. In addition, when considering an analyst recommendation, look at the full research report, not just the one-word rating.

The fact that analysts or their firms may have conflicts of interest does not mean that their analysis is without value. The research reports themselves — as opposed to just the “rating” — often provide useful insights into earnings predictions, company strategy, and comparisons to other companies in the same industry group.

Whatever a given analyst recommendation may say, always consider whether a particular investment is right for you in light of your own financial circumstances. A “buy" rating does not mean every investor should buy the stock just as a "sell" rating doesn’t mean every investor should immediately sell it.

You are the boss when it comes to your own money, and it’s your situation and goals that matter. Your own financial situation and investment needs are what matter, and any individual rating should be viewed in the context of your own unique financial situation.

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