Point of View

Performance Measurement for Equity Analysts

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Each year, the Wall Street Journal publishes its "Best on the Street". The Institutional Investor announces its "All America Research Team". Many more rankings exist applying a wide range of methodologies. While these rankings provide welcome publicity, in particular a purely quantitative methodology might not always do the analysts justice – the desire for a comprehensive approach collides with the wide range of equity rating schemes and resulting analyst mandates.[1]

Next to publicity, measuring the performance of equity analysts can serve a range of purposes from separating the performance of funds managers from that of the research team to identifying the best performing institutes to purchase research from. But how do we arrive at a fair measure?

First, it is important to understand the mandate of an analyst. A "buy" can stem from an expected absolute return of at least x% or from an expected excess return over a specific benchmark (cf. Figure 1). In the latter case – also referred to as relative interpretation -, a negative performance of the security does not necessarily mean the analyst was wrong. If the benchmark lost even more, "buy" was the correct recommendation to give. In case of a relative interpretation using another benchmark than the analyst's reference point can significantly change the understanding (ex ante) or value (ex post) of the recommendation and does not correctly reflect the analyst's abilities. Common benchmarks include sector indices, country indices or the overall universe covered by the analyst.

The rating scale imposed by an institute also needs to be accounted for, especially when comparing analysts across different institutes. Some institutes work on a full five-level scale going from strong buy to strong sell while others reduce this to so little as buy or sell. A full scale intuitively demands putting more weight on the extreme recommendations than on the "normal" ones. But this approach punishes the analyst whose institute does not allow for a (higher-weighted) strong buy. In a portfolio context, the information ratio provides a measure that corrects for such limitations.

Closely related is the question of comparability of recommendation levels across institutes. Some institutes require an expected return of 10% for a buy while others only require 5%. Databases such as IBES (Institutional Brokers' Estimate System) or Factset Research Systems provide a mapping, but even these two disagree regularly. Investars, a commercial software has opted for allowing only three different levels:

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[1] Of course, apart from measurable aspects such as timing, direction or level of the recommendation or EPS and stock selection, any equity study should satisfy certain qualitative standards with a profound, up-to-date, in-depth analysis, reasonable models for the stock price and EPS estimates, proper disclaimers and disclosures and so forth. But in this article, we focus on quantitative measurement of recommendations only.

positive, neutral and negative. While this facilitates comparing analysts across institutes, within an institute it compromises information that is fair to use because it is the same for all analysts.

Reducing the potential levels of recommendations to three would also solve the question of the weighting of the different levels of recommendations.
While AQ Research assigns a standard weight of 1.25 to strong and of 1 for a "normal" recommendation (both positive and negative), ISFA (Information System for Financial Analysts) doubles the weight for a strong recommendation as opposed to a normal one. It has also been suggested compensating the lower number of negative recommendations by a lower weight.

If all those aspects have been addressed, a fair measure can be built. In general, this measure can be based on either geometric or arithmetic outperformance[2]. In any case, the subsequent performance analysis needs to be based on a portfolio and a series of daily returns. While the average outperformance per recommendation or its distribution can provide a first idea, such an analysis does not take into account that different recommendations last for different periods of time. Some results will be correlated because securities belong to the same sector or are subject to the same market conditions when recommended at the same time. Thus, only analyzing the daily returns within a portfolio will enable you to distinguish between luck and talent.

But how to build such a portfolio? Naturally, we want to study the excess returns of a short or long position (depending if the recommendation was positive or negative) over the related benchmark over time. Concurrent recommendations imply several positions at the same time. Unless the analyst is not expected to pay equal attention to all of his stocks, these should be weighted equally. But the equal weighting can either be based on (1) a fixed %, or it can stem from (2) the number of securities in the universe of the analyst or even (3) the number of actively covered stocks of the analyst. If the analyst is mandated to also select which stocks he covers or not, the last weighting ((3) above) models this mandate pretty well. If the analyst is supposed to cover a certain universe, the second weighting ((2) above) is better suited. Finally, the fixed % ((1) above) is independent from the size of the universe of an analyst. On the other hand, the more securities an analyst covers the more chances he has to score.

In summary, to correctly measure an equity analyst's capabilities requires a thorough understanding of the analyst's mandate in order to model his choices and decisions as closely as possible.

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[2] Excess return (also outperformance) refers to either the excess return over the benchmark in case of a relative interpretation or the outperformance over the risk-free asset if the recommendation was based on expected absolute returns.

Figure 1: Equity Rating Definition of Credit Suisse (Switzerland)

Analysts' stock ratings are defined as follows:

Outperform (O): The stock's total return is expected to outperform the relevant benchmark[*] by at least 10-15% (or more, depending on perceived risk) over the next 12 months.

Neutral (N): The stock's total return is expected to be in line with the relevant benchmark[*] (range of +/- 10-15%) over the next 12 months.

Underperform (U): The stock's total return is expected to underperform the relevant benchmark[*] by 10-15% or more over the next 12 months.

[*] *Relevant benchmark by region: As of 29th May 2009, Australia, New Zealand, U.S. and Canadian ratings are based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe[**], with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. Some U.S. and Canadian ratings may fall outside the absolute total return ranges defined above, depending on market conditions and industry factors. For Latin American, Japanese, and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; for European stocks, ratings are based on a stock's total return relative to the analyst's coverage universe[**]. For Australian and New Zealand stocks a 22% and a 12% threshold replace the 10-15% level in the Outperform and Underperform stock rating definitions, respectively, subject to analysts' perceived risk. The 22% and 12% thresholds replace the +10-15% and -10-15% levels in the Neutral stock rating definition, respectively, subject to analysts' perceived risk.*

[**] *An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.*

Restricted (R): In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.