Valentine, James J. – Best Practices For Equity Research Analysts

McGraw-Hill, 2011, [Finance] Grade ★★★

This is as far as I know a unique book. It's in essence a number of check lists covering most aspects of the work description of a sell side equity analyst. The book aims to cater to both the buy side analyst and the sell side analyst. In reality it is the later who is in focus. This is no surprise as the author has been a top ranked sector analyst at a number of US investment banks including Morgan Stanley. According to the author the craft of equity research lacks quality control processes. The profession is mostly learnt through on the job training in a kind of mentor-apprentice–system. You might get lucky and have a good mentor, but on the other hand you might not. Valentine's aim with this book is to develop a best practice for the profession.

The book covers a number of topics such as influencing your research coverage, handling relations within you own organisation and with clients, finding insights to include in research, stock valuation and how to best communicate the research done. Valentine is writing a number of lists of things that often is quite intuitive and basic. The list form is hardly the recipe for a colourful writing and as the same advice is repeated in both the check lists and the text surrounding those lists there is a fair amount of repetition.

There is much in this book that irritates me. However the coverage of topics is comprehensive and I would agree that they probably are close to a best practice for the profession. The advice in this book will both be a good guide for a less experienced analyst and it will remind the more seasoned analyst that he perhaps has neglected one or two aspects of what he could do. There is some good advice regarding psychological pitfalls, too few analysts utilize statistical analysis in the way the author suggests which is a shame and there is also a useful discussion around the best way to build financial models for the companies covered by the analyst.

For an investor, outperformance in the stock market is accomplished by either doing something different from others or by acting like most others but being cleverer than they are. This is a best practice for those who have accepted the professional role as it is, i.e. for those who will run with the crowd. The time horizon for the work of a mainstream US sell side equity analyst is one to six months. With a horizon like that, relative stock performance within a sector is driven by changes in company specifics that are not appreciated by consensus and there is a need for near time triggers. The intrinsic value of the stock is less interesting as valuation is slow-acting.

Here instead, value is something relative within the sector covered. First choice for valuation is to assign a pro cyclical single period multiple to the near term estimate. Growth is seen as the primary reason for differences in multiples, notwithstanding that the spread between return of capital and cost of capital is equally important. Many analysts have a deep knowledge of the companies covered but they are simply momentum analysts.

The author's way to try to create alpha, while at the same time doing the same thing as everybody else, is through focus on three to four key variables. This is the best advice of the whole book. There is no chance you can win by knowing more details than other investors on every topic. There is much to gain from understanding what the key issues for the stock are and then dig deeper around these and recognize the rest of the information is non-important noise.

This is a cookbook to produce the short-sightedness of today's Wall Street, but it is also a unique guide for the person working as a sell side analyst. If you are one, or aspire to be one, you really should read it. I would.

Mats Larsson, January 2, 2012