Return of the Analyst

– Does equity research add value?

August 2013

LEIMDÖRFER

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The value of active investment management and equity research has been debated for a long time. Many studies have shown that actively managed equity funds fare no better than passively managed index funds, and that instead of composing equity portfolios based on research, investors might as well choose shares randomly. 'Market efficiency', it is argued, ensures that share prices reflect all relevant, publicly available information, leaving no money on the sidewalk for investors to pick up.

However, puzzles and conundrums abound on the stock market which – supported by numerous examples of investors having made substantial fortunes investing in and trading listed shares – are brought forward as evidence that stock picking is in fact possible, despite the theoretical appeal of the concept of market efficiency.

Can equity research assist investors in their endevour to find outperforming shares and avoid underperformers? Is stock picking a profitable strategy for the listed property market or should investors instead opt for a sector index fund?

Market efficiency and equity research

The stock market is normally assumed to be efficient in the sense that current share prices reflect all relevant public information. New information that might impact a company's financial position or future earnings is instantly incorporated into the share price, eliminating all information advantages from which an investor would have been able to earn superior returns.

Nevertheless do many investors engage in stock picking, i.e. trying to find and buy shares whose prices they believe will rise and (short) sell shares whose prices they expect are going to fall. Such attempts actually reinforce market efficiency as share prices thereby absorb any private information these investors might possess.

Equity analysts perform fundamental analyses of individual companies, including but not limited to careful reviews of financial reports, market research and meetings with management. Based on their analyses, they issue recommendations to their clients on whether to buy, hold or sell particular shares.

Can investors use these recommendations to build equity portfolios that consistently generate superior returns compared to an appropriate benchmark portfolio?

Does the market leave money on the sidewalk?

Student: *Look professor, there is a SEK 500 bill!*

Professor of Economics: *No, there is not. Had it really been there, someone else would have already picked it up.*

Method

Recommendations from equity analysts on whether to buy, hold or sell particular Swedish listed property shares have been retrieved from the Bloomberg database for the time period 2005-2013. The following analysis comprises eight companies that are tracked by a greater number of analysts than other listed property companies: Atrium Ljungberg (previously LjungbergGruppen), Castellum, Fabege, Hufvudstaden, Klövern, Kungsleden, Wallenstam and Wihlborgs.

Two actively managed portfolios have been constructed and tracked between 2005 and 2013:

- A 'Buy portfolio', which comprises the companies that are assigned more buy recommendations than sell recommendations.
- A 'Sell portfolio', which comprises the companies that are assigned more sell recommendations than buy recommendations.

Both portfolios are rebalanced quarterly, at the beginning of each quarter, to reflect equity analysts' recommendations at these points in time.

The weight of a share within the Buy (Sell) portfolio is proportional to the percentage of analysts who recommends investors to buy (sell) that particular share.

Total return figures for the Buy portfolio and the Sell portfolio are compared with the total return from a passively managed 'Benchmark portfolio', within which the eight shares have the same weight, i.e. one eighth, over the whole time period. The return from the Benchmark portfolio is strongly correlated with the OMX Stockholm Real Estate Growth Index.

Data

The total number of equity analyst recommendations is approximately 2,400, distributed onto 900 buy, 500 sell and 1,000 hold recommendations.

All shares with the exception of Wihlborgs, which in no quarter appears in the Sell portfolio, move between the Buy portfolio and the Sell portfolio at least four times between 2005 and 2013.

Over the studied time period, annual total return has varied significantly between the sample shares. The spread in total return between the best performing share and the most poorly performing share amounts to 15 percentage points per annum. Hence, it should have been possible to generate superior returns by choosing the right shares.

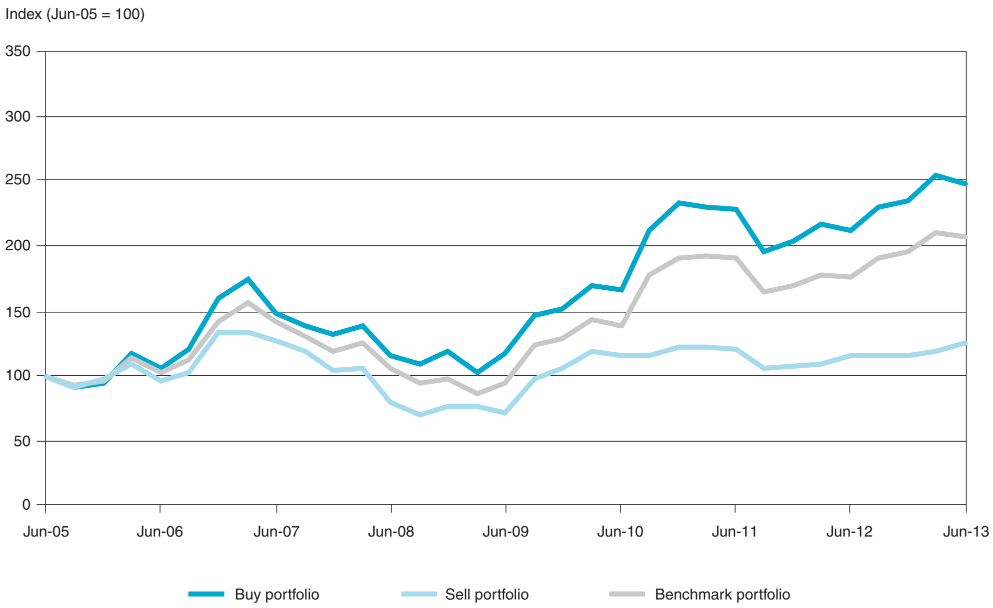
Equity research adds value

Between 2005 and 2013, the shares that equity analysts recommended investors to buy (the 'Buy portfolio') outperformed the Benchmark portfolio by two percentage points per annum in total return terms. This should cover reasonable transaction costs, i.e. commission fees to regularly rebalance the portfolio.

Over the same time period, the shares that equity analysts recommended investors to sell (the 'Sell portfolio') underperformed the Benchmark portfolio by a whole seven percentage points per annum in total return terms. Should transaction costs be taken into account, this spread would of course widen further.

Hence, equity analysts have helped investors to find shares that outperform the benchmark subsequent to issuance of a recommendation and, in an even more precise manner, to avoid shares that underperform other shares after a recommendation has been issued.

Portfolio performance (total return), 2005-2013



By deferring the starting point in quarterly increments, or by ending the time period earlier, also in quarterly increments, 62 unique holding periods of varying length which all lie within the time period 2005-2013 can be studied.

The Buy portfolio outperformed the Benchmark portfolio in close to 75 per cent of these holding periods. The Sell portfolio underperformed the Benchmark portfolio in 95 per cent of these holding periods. Hence, results appear to be dependent neither on the selection of starting point nor on the selection of ending point within the studied time period.

Why sell recommendations are more accurate than buy recommendations

Buy recommendations outnumber sell recommendations. Therefore, the Buy portfolio is more diversified than the Sell portfolio, and the Sell portfolio diverges more from the Benchmark portfolio than the Buy portfolio does. Since the Sell portfolio has underperformed the Benchmark portfolio, this also implies that sell recommendations have been more accurate than buy recommendations.

One explanation for this could be that analysed companies naturally approve more of buy recommendations than of sell recommendations. The latter might therefore limit the equity analyst's access to company information and strain other ongoing business relations the analyst's employer might have with the company.

In addition, the fewer sell recommendations per se makes them more visible to the financial community, with a greater impact on the analyst's reputation and ranking compared to buy recommendations, in particular if they turn out to be incorrect.

For these reasons, sell recommendations can be expected to be issued only when the equity analyst is very confident of their accuracy.

Why stock picking might be possible...

The stock market might not be truly efficient, implying that current share prices reflect less than all relevant public information. This would, over an extended time period, make it possible for investors with deep knowledge about the listed companies and their markets to buy undervalued shares and to avoid or short sell overvalued shares.

Even if the stock market is efficient in the long run and mispricings only temporary, share prices might be 'sticky', i.e. slow to incorporate new information. If that is the case, there would be windows wherein fast-moving investors can benefit from an information advantage before the mispricing is eradicated by market forces.

Should the stock market be characterised by sticky prices, analyst recommendations might themselves drive share prices. If or when investors trade on stock market research, demand for buy-recommended shares grows which makes their prices rise, whereas demand for sell-recommended shares shrinks causing their prices to fall.

…and why it appears to be profitable for the listed property sector

The apparent profitability of stock picking within the listed property sector indicates that it might not be fully efficient, possibly because it represents a rather small fraction of the total stock market. The listed property sector cannot expect to receive as much attention from major investors, such as money managers with broad equity mandates, as other – larger – sectors, resulting in share prices that do not always absorb new information, at least not instantaneously.

Certain characteristics of the property sector, such as contractually fixed rents, a late position in the business cycle and accessible company managements, might help investors and equity analysts to gain information advantages and thereby exploit these inefficiencies.

Moreover, the value of a property company is to a substantial extent dependent upon the market value of its tangible assets, which are – albeit to a varying extent – priced on the direct property market. The relation between the stock market's indirect pricing of the companies' assets, through their share prices, and the property market's direct pricing of the same assets might provide a useful indication of whether a company's shares are undervalued or overvalued by the stock market.

Stock picking based on relative pricing

Leimdörfer's valuation model, 'the Company Overview', derives equity values for the Swedish listed property companies from the direct property market's pricing of their assets, thereby assuming that the direct property market is correct, and that any deviation therefrom by the stock market indicates a mispricing of the shares. (1)

The Company Overview uses as input reported financial information and market yield levels, but makes no company-specific assumptions. Compared to the work of equity analysts, the Company Overview is thus more consistent across companies but less tailored to their individual circumstances and conditions.

Should a company's share price be higher than its equity value as calculated by the Company Overview, the company is said to be traded at a premium. Under the reversed relation, the company is said to be traded at a discount.

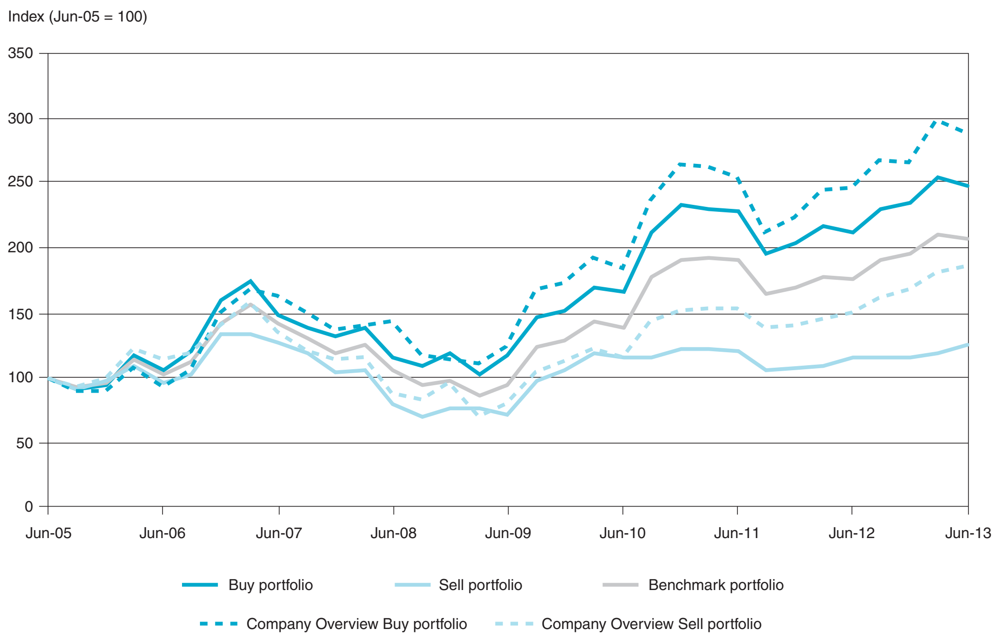
Based on the Leimdörfer Company Overview, two actively managed portfolios have been constructed and tracked over the time period 2005-2013:

- A 'Company Overview Buy portfolio', which comprises the companies that are traded at a discount according to the Company Overview.
- A 'Company Overview Sell portfolio', which comprises the companies that are traded at a premium according to the Company Overview.

Both portfolios have been rebalanced quarterly, at the same preset rebalancing dates as in the analysis of equity portfolios based on equity analysts' recommendations.

(1) Refer to the centre spread of this report for the Leimdörfer Company Overview. In a slightly simplified manner, the equity value is calculated by deducting the company's debt from the direct property market price of its assets.

Portfolio performance including Company Overview portfolios (total return), 2005-2013



Both equity analysts and the Leimdörfer Company Overview have helped investors to find outperforming shares and to avoid underperforming shares, although the extent to which they have done so differs. Between 2005 and 2013, the Company Overview Buy portfolio outperformed the Buy portfolio, and the Company Overview Sell portfolio outperformed the Sell portfolio.

Hence, the Company Overview, which focuses on the relative pricing of assets, has apparently been more successful than equity analysts at finding shares that outperform other shares, whereas equity analysts more accurately than the Company Overview have identified underperforming shares.

Implications for investors

Contrary to what is implied by the efficient market concept, there seems to be money left on the sidewalk for savvy stock market investors to pick up. Over the past eight years, an actively managed property share portfolio based on equity research would have outperformed a passively managed sector index fund.

This indicates that the listed property sector suffers from market inefficiences which investors can exploit by carefully analysing the listed property companies. Relating the prices at which their shares are traded to the direct property market's pricing of their assets might provide useful insights into whether they are fairly priced by the stock market or not.

Should these market inefficiencies remain, which is a realistic assumption, equity research will continue to be a profitable strategy for investors in listed property shares going forward.