INTEGRITY
RESEARCH ASSOCIATES

Analyst versus Model Research

*Article Provided by Integrity Research Associates for Fidelity Investments**

In May 1997, the reigning World Chess Champion, Garry Kasparov, lost a chess match to Deep Blue, a supercomputer which he had beaten the previous year. Deep Blue's error-free play capitalized on Kasparov's lapses, and Kasparov's creative moves didn't stump the machine because the team behind Deep Blue had spent a year teaching the machine Kasparov's style. After its victory over Kasparov, Deep Blue retired rather than face the challenge of another grandmaster's different style of play. In investment research, it is not a question of 'man versus machine' but the Deep Blue/Kasparov chess match illustrates some of the relative strengths of analyst-driven and model-driven research.

Advantages of the Analyst-Driven Approach

Analyst-driven research is better equipped to handle unusual situations than model-driven research. Analysts can adapt to a changing environment more easily than models. A recent example of this occurred in the summer of 2007. In the period leading up to the summer of 2007, quantitative hedge funds were drawn to similar trading strategies by their models, and then lost money when they simultaneously tried to unwind the positions. Most subsequently recovered their losses, but the incident illustrates that models need to be constantly reviewed and updated by analysts to ensure that the factors that behind the models are still relevant.

The biggest advantage of analyst-driven research is that it is often easier to understand the reasoning behind the recommendations. Most of us don't feel comfortable blindly following investment advice—we want to know the logic behind it. Model-driven research firms, particularly the firms offered by Fidelity, have made it easier to understand the key factors that influence a recommendation. For example, Ativo Research and Thomas White International each highlight in their reports the inputs which are most important to making a recommendation. Nevertheless, investors still turn to analyst-driven research to get the 'story' on a stock—what is the reasoning behind the recommendation.

Advantages of the Model-Driven Approach

On the other hand, model-driven research excels in being able to efficiently cover a broad universe of stocks, making it easier to get insights into small cap companies that few, if any, analysts cover. This is valuable to investors since small caps have outperformed large caps over most investment periods—the exception being recessions when smaller firms have more difficulty getting financing.

Models are rigorous and disciplined. They don't overlook the details (provided the details are programmed into the model) or make all-too-human mistakes. They can't fall in love with company management, which is a temptation that analysts have to guard against, whether they work with independent research firms or for large investment banks. And models can quickly update their recommendations when new information is available.

How Do They Perform?

In Integrity Research's quarterly scorecards which review the performance of buy-sell recommendations, model-driven firms typically outperform analyst-driven firms. Partly this reflects inherent advantages in model-driven research, but not entirely. Since performance for research firms is measured across its entire universe of recommendations, model-driven firms have the advantage of covering a greater portion of small cap firms than analyst-driven firms—meaning that some of the model-driven outperformance is simply caused by superior performance of small cap stocks for most of the historical periods we cover.

The other concern with model-driven research is that it tends to have shorter-holding periods than analyst driven research. For example, Standard & Poor's analyst-driven research generally keeps recommendations in place an average of six months, whereas Ford Equity Research, which has consistently demonstrated very good performance in its buy and sell recommendations, keeps its buy recommendations in place slightly over 2 months on average. The tendency of model-driven research to have higher turnover in its recommendations poses a challenge for 'buy and hold' oriented investors, who would have to make more trades—in incur more commissions—to follow the model-driven recommendations. See Integrity's scorecards for firm by firm analysis.

Which to Choose?

The good news is that you don't have to. They each have their advantages and the advantages tend to be complementary. That is why many institutional investors use both. It is not uncommon for investors to use quantitative models to sort through the universe of stocks to identify a smaller number that analysts then research in more depth. Fidelity offers its clients both types of research, and you don't need to limit yourself to either. Some of the research firms, like Zacks Investment Research and Standard & Poor's Equity Research, offer both analyst-driven and model-driven research. Analysts cover the higher profile, more widely held stocks, while models extend the coverage to smaller cap firms. What is important is to keep the relative strengths and weaknesses of the different types of research in mind when using the research.