

Varieties of Stock Research

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Just as there are different investment styles, so it is with investment research. Analysis is a critical component of the investment process, so it is not surprising that there are nearly as many analytic approaches as there are investment approaches. Like investors, research firms may follow one particular analytic methodology, or they may combine different approaches. Part of Integrity Research's job is to evaluate research, and to do this it is critical to understand how the research is conducted. For investors, understanding the different varieties of research not only helps assess it, but also to find the research which best resonates with your own investment style.

Differing approaches

Contrasting research approaches have developed as analysts have looked for new ways to gain investment insights. Some of the key research approaches include:

- **Analyst-driven versus model-driven research.** Most of the research providers we monitor employ analysts to generate research. A growing number of research firms supplement the analyst research with model-driven research, and some research firms only offer research generated from quantitative models.
- **Fundamental analysis versus technical analysis.** Fundamental analysis focuses on finding underlying reasons for stock prices or market movements whereas technical analysis examines patterns in market behavior. Fundamental analysis can be performed by analysts or by models.
- **Growth versus Value.** Growth-oriented research tends to favor stocks that have strong growth prospects whereas value-oriented research favors stocks that are undervalued.

While each of these is a distinct approach, they are not mutually exclusive. Some analytic firms, like Zacks Investment Research, use quantitative analysis as a starting point for their analysts. Some research firms, like Channel Trend or Market Edge, use technical analysis in combination with fundamental analysis.

Analyst-Driven vs. Model-Driven

Analyst-driven research has flexibility to handle information that is out of the norm, which model-driven research finds harder to process. For example, analysts are often better at poring over the footnotes to financial statements to find reporting anomalies (although some quantitative firms, such as Audit Integrity, have constructed models for assessing the quality of financial reporting.)

The other advantage of analyst research is that it typically provides explanations for recommendations. Some model-driven research firms, like Ativo Research and Thomas White International, include in their reports the key factors that determine a recommendation, but often it is harder to understand why a model makes a decision.

On the other hand, model-driven research typically covers a wider selection of stocks, including small cap stocks that are under-covered by analysts. Quantitative research quickly updates its research when new information is available. Model-driven research is disciplined—when factors change, the recommendations change.

In our research firm scorecards, the buy/sell recommendations from model-driven research tend to out-perform analyst-driven research. While there are reasons for this bias, the bottom line is that model-driven research provides good results.

Fundamental vs. Technical

Fundamental analysis comes in a variety of forms, all of which focuses on understanding what drives market valuations. In contrast, technical analysis centers on market behavior, typically the price and volume behavior of securities and markets.

Fundamental analysis can apply to individual securities, such as stocks and bonds, or to markets and asset classes. In the case of stocks, fundamentals would include a firm's financial statements, but also its products, competition and industry dynamics. Fundamental firms don't necessarily address all these factors, as long as they focus on some fundamental aspect. For example, Ford Equity Research calculates a valuation for a stock paying particular attention to the quality of a stock's earnings and earnings momentum. Standard & Poor's analysts are assigned to cover specific industries, and part of their analysis is influenced by industry dynamics and competitive factors.

Fundamental analysis can also be performed on other securities, or on markets. For example, The Hightower Report covers a variety of markets, ranging from agricultural products to interest rates. The firm incorporates fundamental analysis of markets, such as production changes or weather influences for agricultural products.

Technical analysis concentrates on price patterns, including oscillators and momentum measurements. The intent of technical analysis is typically to determine the supply and demand for securities. Technical analysis also incorporates behavioral clues, such as when market sentiment favors particular securities. Technical indicators are more concerned with market timing rather than valuation.

Technical analysis is particularly useful for traders, since it applicable in intra-day markets, as well as longer term investments. Technical analysis is also applicable across securities and markets. Many of the research providers offered through Fidelity.com, combine technical analysis with other types of analysis in making their recommendations. Examples include Channel Trend, Market Edge, Ford Equity Research and Ned Davis Research.

Growth versus Value

Unlike investment managers, research firms don't tend to explicitly follow investment styles such as growth and value. However, certain research approaches which can be viewed as more growth or value oriented.

Research firms specializing in growth-oriented industry sectors, such as technology or healthcare will focus on elements such as new products or new technologies. Growth-oriented research will tend to place importance on factors such as earnings growth, price/earnings and PEG multiples. Earnings momentum (which Ford Equity Research tracks) is another growth-oriented factor.

Value-oriented research will place a premium on valuation analysis, with the goal of finding stocks which are under-priced. Cash flow analysis, which Ativo Research uses, is a valuation technique often favored by value investors. Value investors also gravitate toward earnings quality analysis and forensic accounting, or the type of governance analysis performed by Audit Integrity.

Other Approaches

There are additional research perspectives which investors find value. Many investors appreciate top-down perspectives such as the analysis provided by Decision Economics. Decision Economics monitors big picture developments which help drive overall market or sector performance.

First Call tracks earnings consensus across many different analysts, which is useful in understanding how the market values each stock. First Call provides valuable insights on earnings surprises, which can materially impact stock valuations.

There is growing interest in evaluating the non-financial performance of publicly-traded companies: are they responsible to their various stakeholders, how do they treat the environment, and what is the quality of their governance. KLD Research specializes in Environmental, Social, Governance (ESG) research, focusing on assessing non-financial performance. Audit Integrity comes at the problem from a slightly different perspective, focusing on metrics which gauge the quality of corporate governance.

Which to Choose?

The reality is that you don't have to choose one particular type of research, since each approach can yield valuable insights. You may prefer different types of research depending on the type of investment decision you are making. For example, the big-picture orientation of Decision Economics or broad market coverage of The Hightower Report can be helpful in making asset allocation decisions. When deciding whether to buy a stock, it is useful to get different perspectives from different research providers. Analytically-driven research may provide useful insights while model-driven research can lend conviction. When reviewing an existing portfolio, it might be useful to use the perspective afforded by Audit Integrity or KLD, which can provide early warning signals for trouble ahead. Technical analysis such as provided by Recognia is helpful for making trading decisions—is this the time to buy or sell the stock I've been watching? Most importantly, mix and match—the research providers do it, so you should too.

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