FISHING IN THE DEEP END OF THE POND

Examining Stock Analyst Recommendations

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Anatomy of Analyst Ratings

Equity research analysts typically cover 10-30 public companies each, and together issue thousands of stock recommendations based on a variety of data such as earnings calls, investor presentations, SEC filings, news releases, and conversations and meetings with company management. These recommendations can generally be classified on a five-point scale.

Five-Point Rating Scale

1. Buy, Strong Buy, Recommend
2. Outperform, Moderate Buy, Accumulate, Overweight, Add
3. Hold, Neutral, Market Perform
4. Underperform, Moderate Sell, Weak Hold, Underweight, Reduce
5. Sell, Strong Sell, Avoid

Most large-cap and mid-cap stocks are covered by multiple analysts. Financial data providers such as Thomson Reuters and Bloomberg combine these analyst ratings to derive a consensus rating for each stock.

Stock analysts are smart and certainly know more about the stocks they cover than the average investor. So, building a winning investment portfolio should be simple, right? Just buy the consensus top-rated stocks!

It is not that easy. As it turns out, investors have achieved better returns over the last 15 years by avoiding the top-rated stocks. We share our research findings below and examine the reasons for this counterintuitive result.

The Tortoise and the Hare

First, we used Bloomberg to test the consensus ratings for the S&P 500 Index over the last 20 years (May 31, 1996 to May 31, 2016), rebalanced monthly and broken into quartiles.

Stock Performance Based on Analyst Ratings
(May 31, 1996 to May 31, 2016)

Consensus Rating	Return[1]	Volatility[2]
Top 25%	9.0%	17.6%
Second 25%	9.8%	17.9%
Third 25%	11.6%	17.7%
Bottom 25%	10.7%	18.7%
Universe Average	10.3%	17.5%

The top-rated basket of stocks outperformed the other baskets in the “go-go” days of the late 1990s, but have been the worst performing group since early 2000.

Next, we analyzed the S&P 500 consensus ratings in our Compustat-powered database from January 1, 2001, to May 20, 2016, rebalanced weekly and broken into halves.

Stock Performance Based on Analyst Ratings
(January 1, 2001 to May 20, 2016)

Consensus Rating	Return[1]	Volatility[2]
Top 50%	7.6%	17.3%
Bottom 50%	10.1%	19.9%
Universe Average	8.9%	18.3%

Both databases use point-in-time data, and are free of survivorship and look-ahead bias. The results speak for themselves.

Raising the Question: Why?

The impact and performance of analyst recommendations have been studied for nearly 100 years, beginning with Alfred Cowles' article "Can Stock Market Forecasters Forecast?"[3]

Pursuant to a working paper entitled, "Analyzing the Analysts: When Do Recommendations Add Value?" by Narashimhan Jegadeesh, et al (2001)[4], the following reasons may account for the disparity in performance between top- and lower-rated stocks.

• Analysts tend to shy away from recommending stocks that are positioned to take advantage of the "value anomaly"
• Instead, analysts tend to prefer "glamour" stocks (high in momentum, sales growth, and valuation multiples)
• These "late stage" momentum plays can be particularly vulnerable to subsequent price reversals
• Analysts' preference for "glamour stocks" could result from economic incentives imposed by their operating environment (sell-side firms)

Our Bloomberg research confirms that analyst recommendations worked best during the late 1990s when "momentum" ruled and "value" struggled. In a bulletin about stock recommendations, the Financial Industry Regulatory Authority (FINRA) outlines potential conflicts of interest inherent in the analysts' operating environment:

A large number of analysts are employed by institutions whose financial stake in their recommendations may go well beyond their accuracy. For example, many analysts work for large financial firms that underwrite securities. An underwriter acts as an intermediary between the company publicly offering securities and investors buying the new stock. Even after the initial public offering, or IPO, it may have an ongoing relationship with the company or own a significant amount of the company's stock. It will often stand to benefit from analyst recommendations that would tend to support the price of, or encourage trading in, that security.

Other analysts work for institutional money managers, such as mutual funds, hedge funds or investment advisers. They may provide research and advice for institutional clients whose investment decisions can differ significantly from those faced by ordinary investors. A mutual fund that relied on its analyst's earlier positive recommendation in acquiring the stock of a company might be harmed by any revised recommendation that would tend to lower the market value of the security.

These economic realities certainly do not mean that analysts are corrupt or even biased. But because analysts are called upon to make so many judgments that are not black and white, any of the above factors can put pressure on their objectivity — no matter how honest or competent they may be. So, you should bear these realities in mind before making an investment decision.

While FINRA makes some valid points, we do not ascribe any sinister motive to the analyst in making his or her recommendations. Rather, human nature tells us it is easier and more comfortable to recommend what has been working in the recent past. Conversely, it may feel riskier to these professionals to recommend a stock that may be out of favor due to fear of being wrong. It is safer to conform to the herd, and this urge to safety is strong.

Taking Full Advantage

How can an investor or wealth advisor use our research results to their advantage? Go to www.morningstar.com and check the top 25 holdings of the mutual funds and ETFs in your portfolio. If you see a lot of "Wall Street darlings" or "glamour stocks" at the top of the list, beware that the fund may be swimming upstream in terms of performance.

At Kerns Capital Management, we have the flexibility to invest in just about any asset class. However, when we allocate to domestic stocks, we prefer to fish in the deep end of the pond. You will not find many glamour stocks in our portfolio. Instead, we generally search for stocks with strong fundamentals that Wall Street has overlooked.

[1]Measured by compound annual growth rate (CAGR).
[2]Measured by annualized standard deviation of returns.
[3]Published in Volume 1, Issue 3 of Econometrica in 1933.
[4]http://faculty.som.yale.edu/zhiwuchen/Investments/Analyst.pdf
[5]http://www.finra.org/investors/understanding-securities-analyst-recommendations

Kerns Capital Management, Inc. manages the KCM Macro Trends mutual fund ("KCMTX"), a flexible, opportunistic long/short equity fund without style box restrictions that is free to control its equity exposure with short positions, as well as invest in bonds, alternatives, and foreign investments.

Investors should carefully consider the investment objectives, risks, charges and expenses of the KCM Macro Trends Fund. This and other important information about the fund is contained in the prospectus, which can be obtained at www.kernscapital.com or by calling 800.945.2125. The prospectus should be read carefully before investing. The KCM Macro Trends Fund is distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Kerns Capital Management, Inc. is not affiliated with Northern Lights Distributors, LLC.

Mutual funds involve risk including possible loss of principal. The fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. The fund may use leveraging and/or hedging techniques that could fail if changes in the value of the derivative do not correlate with the securities being hedged. The fund may also engage in short selling activities, which are riskier than "long" positions because the potential loss on a short sale is unlimited. These risks may result in greater share price volatility.

[1] Corresponding indexes – S&P 500: Standard & Poor's 500 Index (an unmanaged composite of 500 large capitalization companies widely used by professional investors as a performance benchmark for large cap stocks.)

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For more information, please visit

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