# **Topic 5 – Equity Analysis II (The Big Picture)**

♠ indicates questions to be discussed during the tutorial. Due to time limits, other questions may not be covered during the tutorial. Still, they are helpful for checking your knowledge and preparing for upcoming quizzes and other assessments in your own time. Once all tutorial classes during the week are finished, we post the detailed solutions to all tutorial questions on Moodle.

♠ **Q1.** Differentiate sell-side and buy-side analysts and describe the differences in their incentives. What potential biases may be present in the work of these two types of analysts due to the divergence in their incentives?

Answer:

Buy-side analysts are employed **by investment firms** to write equity research reports on a firm’s future performance and make recommendations (Buy / Hold / Sell) with regards to the firm’s stock. Based on these recommendations, the investment firm may make the decision to buy/hold/sell stocks on behalf of its clients in the funds that it manages for its clients. Sometimes, investment firms also trade on their own account (i.e. investing their own money instead of its clients’ managed funds). Buy-side analysts are valued depending on **whether they can issue investment recommendations that are profitable**, which brings in new fund inflows and generate fund management fees and bonuses.

Sell-side analysts are employed **by brokerage firms** to write equity research reports to sell to the firm’s clients, including retail and institutional investors. These investors then decide on the course of action, and may use the brokerage services provided by the brokerage firm to execute the deal. Sell-side analysts **are valued based on the number of trades that the clients execute, which generate trade commissions**. Hence, sell-side analysts may be less long term oriented than buy-side analysts. However, if they consistently produce poor quality research reports, investors will not follow their recommendations, and the trade commissions will be adversely affected. Sell-side analysts may also assist the investment banking arm of the brokerage firm to promote IPO/SEO shares.

Buy-side analysts may also use the equity research reports issued by sell-side analysts but they would need to evaluate the quality of these reports.

Sell-side analysts may be prone to being overly optimistic (***positive bias***) to secure and maintain access to the firm to obtain information and generate businesses for their investment banking arm. On the other hand, they may also bear the pressure from the firm’s management to keep the consensus low (***negative bias***) so that the firm can beat analyst forecasts and maintain its share price at a high level.

♠ **Q2. BKM Ch.12, Q19.** Here are four industries and four forecasts for the macroeconomy. Choose the industry that you would expect to perform best in each scenario.

Industries: housing construction, health care, gold mining, steel production.

Economic Forecasts:

* Deep recession: falling inflation, falling interest rates, falling GDP.
* Superheated economy: rapidly rising GDP, increasing inflation and interest rates.
* Healthy expansion: rising GDP, mild inflation, low unemployment.
* Stagflation: falling GDP, high inflation.

Answer:

* Deep recession: falling inflation, falling interest rates, falling GDP – **health care (non-cyclical)**
* Superheated economy: rapidly rising GDP, increasing inflation and interest rates – **steel production (cyclical)**
* Healthy expansion: rising GDP, mild inflation, low unemployment – **housing construction (cyclical, but interest rate sensitive)**
* Stagflation: falling GDP, high inflation. – **gold mining (counter cyclical)**

First, cyclical industries perform better during an economic expansion, while noncyclical industries perform better during recessions. Housing construction is a cyclical industry. But it’s also sensitive to interest rates since many houses would be bought through mortgages. Thus, housing construction would perform better than others during healthy expansions. Health care is a noncyclical industry and thus will perform better than others during a deep recession. Demand for health care doesn’t depend on a business cycle, and therefore healthcare companies’ earnings are relatively protected from recessions. Gold mining would probably perform better than others in stagflation since it’s a countercyclical industry that protects against high inflation since gold price is relatively independent of inflation. Finally, the steel industry, a highly cyclical industry, would probably perform best in a superheated economy when demand for steel increases as the economy is booming.

**Q3. Final exam S1 2022**. Which of the following is **NOT** a typical part of an equity research report?

1. Description of the company, its products, and services
2. A description of the company management’s political connections
3. A forecast of the company’s future financial performance
4. A recommendation to buy, sell or hold a stock

Answer: b).

**Q4.** **Final exam S1 2022.** Macroeconomic analysis performed by equity research analysts can help them to:

1. Narrow down the subset of stocks for potential equity research consideration
2. Understand the growth opportunities of companies that they research better
3. Estimate the required rate of return on companies that they research
4. All of the above

Answer: d).

**Q5.** **Final exam S2 2022.** Since \_\_\_\_\_\_\_\_\_ industries perform better than other industries during economic recessions, equity research analysts usually focus on companies from industries like \_\_\_\_\_\_\_\_\_\_\_\_ when the economy is stagnating.

1. cyclical… mining and airline
2. defensive… mining and airline
3. cyclical… fast-moving consumer goods and utilities
4. defensive… fast-moving consumer goods and utilities

Answer: d).

**Questions for personal study outside of class**

**Q6.** Read the Financial Review article about a recent failure of sell-side analysts. The article discusses how sell-side analysts failed to predict a huge drop in Meta’s (Facebook’s) earnings in the first quarter of 2022. What factors contributed to the analysts’ failure?

Answer:

There are several factors contributing to the analysts’ failure. First, analysts are very reluctant to issue “sell” recommendations (only 5% of S&P 500 stocks have “sell” recommendations). So even if analysts are negative about a company’s earnings, they would rather issue a “hold” rather than a “sell” recommendation. This happens because analysts often are afraid to lose their relationship with the company’s executives if they issue a negative report about the company. Bearish analysts may simply lose access to executives, making it harder to get information about the company and do their job. Second, the herding behavior of analysts contributed to their failure. Specifically, 84% of analysts recommended buying Meta. In this situation, many analysts may have preferred to go with the crowd and issue a “buy” recommendation rather than against it. If everyone fails, it’s easier to share the blame of your client by explaining to them that it was tough to predict, and everyone, not only you, failed. While if you recommend selling, while others advise buying, all blame from your client will be on your shoulders.