

Unexpected Praise From the Ivory Tower

SECURITIES analysts, highly paid as they are on Wall Street, often get precious little respect from academics. Perhaps the analysts' biggest ignominy was research conducted in the late 1970's, whose conclusions since have become part of the ivory tower's canon. According to those devastating studies, the average stock that has no analyst following it actually outperforms the average stock that does.

Securities analysts, therefore, are to be excused if they initially scratch their heads over a new study written by Brad Barber, a professor at the University of California at Davis, and three of his colleagues at Berkeley and Stanford. These professors not only reached the opposite conclusion from that of those earlier studies; they also discovered that securities analysts are actually able to pick stocks that outperform the market.

Is nothing sacred?

Using data from Zacks Investment Research, the professors studied more than 360,000 recommendations made between 1985 and 1996 by more than 4,000 brokerage firm research analysts. The professors constructed a consensus recommendation for each stock based on the average advice of all analysts who followed it. They then constructed several portfolios from these consensus recommendations. For example, one portfolio had only the stocks with the strongest favorable consensus recommendations, while another had just those with the weakest.

The results? Over the 11 years through the end of 1996, the portfolio containing stocks with the strongest consensus recommendations gained an annualized 18.8 per-

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Analyst Power

Five portfolios were constructed based on analysts' consensus recommendations. Portfolio 1 contained the strongest buy recommendations, and Portfolio 5 the weakest. Performance was measured from January 1986 through December 1996. The analysts' top choices beat the market.

Analysts' consensus		Annualized return
Most favorable	Portfolio 1	18.8%
	Portfolio 2	17.9
	Portfolio 3	15.2
	Portfolio 4	13.5
Least favorable	Portfolio 5	5.8
	Wilshire 5000 index	14.8

Source: "Can Investors Profit from the Prophets? Consensus Analyst Recommendations and Stock Returns," by Brad Barber, Reuven Lehavy, Maureen McNichols and Breit Trueman. Available at www.gsm.ucdavis.edu/~bbarber.

cent, beating the Wilshire 5000 by 4 percentage points per year. Even more impressively, it outperformed the portfolio containing the stocks with the weakest recommendations by 13 percentage points a year.

It's unlikely that this result is a fluke. For example, the professors found that, without exception, the most favorable consensus recommendations outperformed the least in each of the 11 years. And similar results were reached in my own study of security analysts who write investment newsletters. According to my calculations, between 1980 and 1996, a portfolio of investment newslet-

ters' most-recommended stocks beat the market by 3 percentage points a year.

Before you rush out to buy the consensus recommendations, however, you need to be aware of two things. First, the professors found that their pattern was most pronounced for small- and mid-cap stocks. For the few hundred largest companies, like many in the Standard & Poor's 500-stock index, they found no significant difference in the performance of the stocks that analysts liked the most and those they liked least.

Second, none of the studies took transaction costs into account. Such costs can easily defeat the strategy, because the turnover rate for following the highest consensus recommendations can be more than 300 percent a year.

But the negative effect of the transaction costs on this strategy's return should not unduly disappoint investors. All it means is that the consensus of analyst recommendations can't stand as the only factor you look at when constructing your portfolio. But that doesn't mean it can't play a valuable supporting role.

When you've decided to buy stocks, for example, you've already committed to paying a commission and a bid-ask spread anyway. In such a case, the professors' study suggests that it would be worth your while to take into account the consensus of analyst recommendations.

This advice applies even more strongly when you have decided to sell some of your stock holdings. This is because the least favorable consensus recommendations underperform the market by even more than the most favorable ones outperform.

Where can you find the consensus recommendations on particular stocks? They are widely available on a number of Internet sites, including cbs.marketwatch.com. Alternately, you can subscribe to services like Analyst Watch, published by Zacks (www.zacks.com).