Chapter 7

Identify Factors that Impact a Sector's Valuation and Performance

Great analysts are those who work on a more macro level. Most equity analysts are expected to look at stocks from a bottom-up approach. Those who can also look at them from a top-down approach have a competitive advantage.

—Drew Jones, former Associate Director of Research at Morgan Stanley

Introduction

When you hear the quote, "Those who cannot remember the past are condemned to repeat it,"* it likely conjures up historical images such as war and famine, but it also has relevance for security analysis. During my career, clients would call daily asking for *company* details, but it was rare to get a request for *macro* or *sector* information, which was an indication of the lack of work being done at that level. In the 1990s,

* From George Santayana, philosopher, novelist, and poet (1863–1952).

the limited investors who conducted historical work on the railroad sector quickly realized that it hadn't earned its cost of capital in 50 years, primarily because of (1) powerful labor unions extracting above-market wages and benefits; (2) fierce competition from trucks that received indirect government subsidies in the form of low highway taxes; and (3) a dying industrial customer base. Those who didn't fully appreciate these secular factors, which included many sell-side and buy-side equity analysts, were likely to miss the overriding factors that would eventually separate successful company strategies from those destined to fail. For example, at the time, Illinois Central had unique strategies to leverage its unionized workforce better than the competition, and to focus on hauling freight in sectors that were less truck-competitive, enabling it to overcome two of the three secular problems mentioned above. Its stock more than doubled between the end of the '91–'92 recession and early 1998 (before being purchased by Canadian National), substantially outperforming its major peers. It's critical to conduct *sector* analysis in order to put *company* performance in perspective. Reena Bajwa, equity analyst, UBS Global Asset Management, makes this point when she says, "Understanding the industry and understanding the stocks are two different skills."

After an analyst has been assigned a sector(s), the most common mistake is to immediately start researching companies. In doing so, one fails to look at the sector as a whole, which is necessary to put the companies and their performance in perspective. It would be similar to a pilot who has a clear understanding of his or her destination, jumping into the plane without first checking the weather. Companies don't operate in a vacuum; they compete within a sector. More importantly, the largest factor in explaining a portfolio's performance relative to its benchmark is usually sector selection. As such, equity analysts must understand when their sector tends to historically outperform and underperform the market, something missed by many analysts. This critical step is advocated by many successful practitioners, including

BEST PRACTICES FOR EQUITY RESEARCH ANALYSTS

ESSENTIALS FOR BUY-SIDE AND SELL-SIDE ANALYSTS

Identifying Factors That Drive the Stock

Creating Financial Forecasts

Mastering the Practical Valuation Tools

JAMES J. VALENTINE