Chapter 8

Identify and Monitor a Stock's Critical Factors

The toughest part of the job is filtering out the material information from the noise.

—Celeste Mellett Brown, a Morgan Stanley analyst with more than 11 years' experience

The most distinguishing element of great analysts is that they put a disproportionate amount of time into forecasting only a few of the factors likely to move their stocks. This approach turns the traditional company analysis on its head because they're not attempting to know everything about their companies. The problem many analysts have is that they approach company analysis similarly to college students, highlighting all 300 pages of their textbooks to ensure that everything is understood for the final exam. Great analysts focus their time on only those questions that have been asked in prior exams or, due to a change in the environment, are likely to be asked on the next exam. A seasoned manager of analysts echoes this view with, "There's an opportunity for analysts to do a better job pre-defining the drivers of a stock and why investors own the stock."

Because this best practice requires that work be done on every stock within the assigned universe, it lends itself best to analysts who have a manageable number of stocks (e.g., *closely* follow 50 or fewer on the buy-side or 7 or fewer per team member on the sell-side).

What Makes a Factor Critical?

Identifying mispriced stocks requires information not widely understood or accepted by the financial market. When this information will likely move a stock during the analyst's typical investment time horizon, we call it a *critical factor*. The best analysts focus the majority of their time on identifying and monitoring these critical factors to develop an edge. After all, there are many more factors that *will not* move a stock than *will*.

It can be a challenge to identify critical factors, especially for someone new to a sector, which is why I've created the criteria below. For an issue to be a critical factor, it should meet both of the following standards:

- Occur during the investor's typical investment time horizon.
- Have an associated catalyst that, when triggered, will cause the factor to become a greater opportunity or risk in the view of market participants. In most instances, this factor causes one or more of the following:
  - Material changes in earnings or cash flow growth.
  - Material changes in returns.
  - Material changes in the probability:
    - The company makes an acquisition.
    - The company is purchased by another entity.
    - There is a change in senior management.
  - Material change in the volatility profile of the stock.

Analysts will have different thresholds for measuring materiality based on their fund's objective, time horizon, and the sector being analyzed. We use 5 percent and 50 basis points as starting points to help

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