

Chapter 20

Overcome Challenges to Creating Discerning Stock Calls

I don't have any trading secrets that guarantee stock-picking success. If I did, I would be selfishly hoarding them on a private tropical island I'd purchase with the windfall. In truth, it's not that I haven't found them, but that they don't actually exist. Through my entire career working with hundreds of sell-side analysts at Wall Street's largest firms to the thousands of clients I've met, I've never come across a low-risk, high-return investment strategy that could be used with consistency. I mention this first because I find some analysts spending more time seeking this Holy Grail than producing high-quality fundamental research.

It's probably worth mentioning that the discussion in this section is limited to stock picking using a fundamental approach; I cover the technical approach later in Chapter 22. Many portfolio managers prefer their analysts not use both a fundamental and technical approach simultaneously, at least not until the fundamental work is done.

Stock picking is one of the few areas where sell-side analysts have it better than buy-side analysts. Both types of analysts are required to make stock calls, but sell-side analysts can have long and rewarding

careers even as mediocre stock pickers, because their clients aren't necessarily paying just for stock calls. With that said, sell-side analysts who are good at every other aspect of the job *and* can pick stocks are rewarded for these efforts. The buy-side isn't as forgiving, because stock picking is usually the major component in setting compensation.

Dennis Shea, who spent many years as a highly ranked sell-side analyst and a senior manager of both sell-side and buy-side analysts, has an insightful view about the qualities that make up a great stock picker:

- Dispassionate, namely, they don't allow nonrelevant factors to cloud their judgment.
- Stick to their discipline and strategy over the long-term.
- Self-aware of where they have expertise and where they don't.

Challenges with Stock Picking

It's important not to confuse valuation with stock picking. There were many people by mid-1998 who could clearly show technology stocks were overvalued, but their bearish calls would have been bad stock picks for another 18 months, well beyond the typical institutional investor's time horizon. Stock picking involves art and science. As highlighted in Exhibit I.1, the science part comprises the primary tasks discussed to this point: identifying critical factors, creating financial forecasts, and using valuation to derive a range of price targets. This last phase also has elements of science within it, but in order to truly achieve success, an analyst must learn the *art* of stock picking.

Experienced practitioners know stock picking is the hardest part of the job, in part due to these challenges:

- All of the information needed to make a perfect stock call is rarely available. My work shows that analysts appreciate this

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