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A Few Stars Still Shine Among Analysts

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While analysts have seen their reputations trashed over the past couple of years, there are a few analysts who can still make you money.

According to analyst tracker Investars, the three most successful stock-picking firms in 2002 -- **Parenteau**, **Avalon Research** and **Analytiq Research** -- were independent research houses, while 12 of the top 20 firms were boutique investment banks. The fact that a number of investment banks ranked so highly may come as a surprise to investors who have grown to believe that any research from such firms is tainted.

RTX Securities, an investment bank focusing on emerging-growth companies, and **Hoefer & Arnett**, which focuses on banking and technology, were ranked No. 4 and No. 5, respectively, on the Investars list. If investors had followed the recommendations at these firms, they would have seen returns of 9.5% and 8.4%, respectively. If investors had followed the guidance of Parenteau, Avalon Research and Analytiq Research, they would have reaped returns of 18.2%, 18.1% and 10.7%, respectively. Meanwhile, the **S&P 500** shed 23% last year.

Sandler O'Neill and **Ryan Beck & Co.** were also among investment banks that did well in 2002, according to Investars.

The Methodology

Investars ranks companies by creating a hypothetical portfolio based on the recommendations of each firm. It theoretically buys stocks when an analyst issues a buy rating and shorts stocks when a sell rating is issued.

A separate study released by analyst tracker Starmine ranked **Morgan Stanley** (MWD:NYSE - news - commentary) as the best firm for 2002 in terms of its stock-picking ability and the accuracy of its earnings forecasts. Starmine ranked **Lehman Brothers** (LEH:NYSE - news - commentary) as No. 2, followed by **UBS Warburg** and **Credit Suisse First Boston**. Starmine didn't break out the rates of return and vice president David Lichtblau said investors shouldn't use that as a proxy for whom to listen to on a specific stock or industry. Also, it's worth noting that Starmine doesn't evaluate many of the independent research shops that are tracked by Investars. It also uses a different methodology to determine its results.

To some extent, though, Starmine's data confirm Investars' data, showing that analysts from boutique investment banks are often worth listening to. For example, Starmine singled out Sandler O'Neill insurance analyst Nick Pirsos as the best stock picker for last year. Sandler O'Neill specializes in banks and insurance.

The stocks in Pirsos' coverage universe were up 9% on average last year, while Pirsos' portfolio --

created by overweighting his strong buys and buys, and underweighting his holds and sells -- was up 34%, according to Starmine. One of Pirsos' best picks was **Selective Insurance Group** (SIGI:Nasdaq - news - commentary) , which gained 42% during the periods that he had a strong buy rating on it, Starmine said.

A portfolio constructed only of the stocks that he rated a strong buy would have returned 48%. Similarly, a portfolio of stocks he rated a sell would have declined by 64%, the firm said.

StarMine evaluates an analyst's performance by simulating portfolios based on his or her buy, sell or hold recommendations. However, the firm also creates a unique benchmark for each analyst based on his or her particular coverage list. Then the company overweights stocks that are recommended highly and underweights stocks rated hold or sell.

"To get a high score, you need to put the highest ratings on stocks that did the best and the lowest ratings on stocks that did the worst," said David Lichtblau, vice president at Starmine. "We focused on the skills the analysts had, given the hand they were dealt."

The methodology seems to allow for fairer comparisons because analysts can't simply do well by virtue of following a highflying stock or industry. Simply looking at buy, sell and hold recommendations during the bubble years would have made Internet analysts look like geniuses, because the majority of them had buy ratings on stocks and most did well amid all of the euphoria. But that would have said little about the analysts' true ability to pick good stocks.

A Fair Comparison

Still, Starmine's methodology also means that an analyst can get a high score even when his or her stock recommendations underperform those of other analysts. On an absolute basis, for example, Pirsos wasn't the best insurance analyst last year. In fact, he came in second after Bijan Moazami of Friedman Billings Ramsey, according to Starmine. (Incidentally, Investars ranks Friedman Billings Ramsey as the top investment bank covering 500 companies or more for last year, with a negative return of 4.8%.)

Coming in at No. 2 on Starmine's stock-picking list was Putnam Lovell Securities' analyst Richard Repetto, who follows the financial industry. Repetto's best pick in 2002 was **Lending Tree** (TREE:Nasdaq - news - commentary) , which reaped a total return of 122% during the period that he rated it a strong buy, the analyst tracker said.

Langen McAlenney insurance analyst Steven Labbe, Banc of America's food-products analyst William Leach and JSA Research aerospace analyst Paul Nisbet round out the top five. Langen McAllenney and Putnam Lovell are investment banks specializing in insurance and finance, respectively. JSA Research offers research only.

Kei Kianpoor, CEO of Investars, notes that smaller firms often come out on top simply because they cover fewer stocks. "It is just easier to post enormous returns when you have a smaller stock universe coverage," he said. "That being said, the fact that Avalon Research covers fewer stocks and can devote an enormous amount of time and resources digging information on each one is also a reason the smaller firms outperform the big ones."

The fact that so many good analysts come from small investment banks shows that these brokers should start publishing their analysts' track records, because this is the best way of separating the good from the bad.

Although some brokerages, such as **Lehman Brothers** (LEH:NYSE - news - commentary) , have started publishing historical records of their analysts' ratings on their Web sites, the information is difficult to locate, and it's not available in research notes. A new rule proposed by the **NYSE** and NASD could change that in the future, but for now, investors are forced to rely on an independent third party.

Among firms covering 500 stocks or more, Investars notes that nine of the top 10 last year were independent research shops, with Friedman Billings Ramsey the only bank to make the list.