AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive 25th September 2015

Stock-picking Stockbrokers ???

The media, sections of the market and the companies themselves pay close attention to how analysts at the large investment banks rate individual companies, despite their frequent changes of opinion. Depending on the influence of the analyst in question, "**Buy**" calls are greeted with joy and gains, "**Sell**" causes concern and falls. "**Neutral**" calls tend to result in ambivalence and questions from the bank's hedge fund sales desk as to why research are publishing a 40 page note advising clients to do nothing.

Earlier this week one of the investors in Aurora's Dividend Income Trust asked me how closely we follow the stock calls offered by analysts at investment banks. In this piece we are going to run through the strengths and weaknesses of research and how we as investors can best utilise their work to improve portfolio returns.

Perpetual Motion

Investment banks should be viewed as sharks, but not in the sense that they are cold blooded oceanic predators, but rather like sharks, they need constant movement in order to stay alive. Sharks breathe through a technique called ram ventilation and by swimming, sharks actively force water into their mouths for processing much like the fees from facilitating trading and IPOs keep the investment banks alive.

Whilst global investment banks may have hundreds of investment professionals globally writing research on companies, commodities, economies and industries, their business focus is not managing money or building portfolios, but rather generating commissions from client trading on the advice given.

For a stockbroker earning 0.1% to 0.2% commission on every trade, the bank earns nothing if you deceide to hold onto your postion in Wesfarmers or Telstra. Consequently the natural bias will be towards writing research that will encourage fund managers (and also individual investors) to switch from one security to the other. Whilst we are happy to make decisive calls

when we believe that something has fundamentally changed in a company's prospects or where we see an opportunity to capture additional franking credits, execssive short-term switching transfers wealth from the fund to the stockbrokers.

Which Side is the Bread Buttered?

Over the past three years we have recieved on average 3 IPO (Initial Public Offering or float) prospectuses per week, along with invitations to meet with management and the accompanying analyst reports. The research from the sponsoring brokers invariably contains glowing reports of the company's future prospects. These new issues are sold on a caveat emptor basis and the research analysts are now seperated from the investment bankers by "Chinese walls" and are no longer remunerated based on writing a postive report (post the 2003 Global Analyst Research Settlement which levied US$1.4 billion on the global investment banks, after finding inappropriate influence of their research analysts by their investment bankers seeking lucrative fees)[1].

It is worth noting that the investment bank writing this research can generate fees anywhere between 1-3% of a new issue. As the sum total of IPOs over the last 18 months is in excess of A$19 billion, there is little incentive for a critical report on a new company to be written when there is a fee pool in excess of A$190 million in Australia alone to be fought over!

Furthermore, before enjoying a brief stint at a large US investment bank as an equity analyst, I was puzzled at the number of small changes issues by analysts, such as issuing a research note for a small change in their earnings per share target or switching from a buy to a neutral due to an often temporary move in a company share price. This occurs as these changes not only feed into the momentum models for quantitative funds, but provide the sales desk a reason to call their high trading clients.

Know the Bias

Similarly, analysts writing the research also have to consider the long-term relationship between the company that they are rating and their bank. In certain sectors companies react poorly to research being published rating them as a "Sell" and threaten to reduce that analyst's access to the company in question. This is often why you see brokers rating a stock as "Neutral" or "Hold", a rating that is meaningless for most investors.

Obviously if an analyst's access to a company's management is reduced, then their ability to understand the inner workings of that company could also be impaired. Similarly the analyst's bank may find it harder to secure lucrative corporate work such as debt issuance or equity raisings if their research has a negative view of that company. Last week I wrote a piece on Woodside's recent bid for Oil Search ***Cash Burning a Hole in the Pocket***. Afterwards I asked a prominent oil and gas analyst whether I was too harsh on Woodside or was missing something given that he had been much kinder to the company in his research reports. He responded that he wasn't able to put the boot into the company. Furthermore, it is also common practice that research departments will be prevented from writing research when their investment bankers are advising on an acquisition. This convention resulted in almost no research being published on BHP and Rio for a 12 month period in 2008, as almost every investment bank was tied up in the potential mega-deal.

Useful Industry Experts on Tap

Whilst the above few paragraphs paint a relatively negative picture of the sell side it would be manifestly wrong to claim that the mostly hardworking and smart sell side analysts don't add any value to the investment process. At Aurora we use the sell side analysts to leverage their expertise as industry experts in the areas in which companies we own operate. Similarly we use them to test our theories of how events will impact a particular industry such as new competitors in the Australian grocery industry or longer-term Asian demand for natural gas.

Most institutional fund managers build their own financial models and arrive at investment conclusions based on their own research; analysts at the investment bank however can spend decades concentrating on analyzing complex industries like insurance or pharmaceuticals and it would be wrong not to leverage the depth of their knowledge and industry contacts to improve the returns of our portfolios.

[1] Merrill Lynch analyst Henry Blodget famously rated the stock of one company, Lifeminders, as a "P-O-S" on his home computer while plugging that same stock to investors as a solid buy. Rebecca Leung, *The Sheriff of Wall Street: Eliot Spitzer Takes on the Brokers and Wins*, CBS NEWS (May 23, 2003)

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It doesn't make sense for even the largest fund managers to have a chemicals expert on staff, but it can be extremely useful to be able to call one whenever you have an issue or concern or to compare two brokers that have differing views on a stock that may be in the portfolio. The brokerage that investors in Aurora's funds pay is an asset that we use to generate returns for the clients.

In the interests of full disclosure, the author of this note was formerly a lead analyst at a large US-based investment bank and hopes to remain on friendly terms with a range of individuals still working for US and Swiss-based investment banks.

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- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**
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