

Kiplinger's

PERSONAL FINANCE

Who PICKS the best stocks

RESEARCH | We help you sift through the jumble of voices telling you what to buy and what to sell. *By David Landis*

BUYING STOCKS ON THE SAY of a brokerage analyst is a bit like trusting the TV weatherman. He seems to know what he's talking about, and his forecasts are often on the money. But sometimes he is very, very wrong, and when he is, you're the one who gets soaked. So whose research should you rely on?

We sought the answer to that question and got some big surprises—four of them, to be exact. Four of the six top-ranked providers of stock-buying advice are firms you've probably never heard of. And the number-one stock adviser could fit its entire staff into a luxury suite at Petco Park in its hometown of San Diego.

We asked Investars, a New York City-based firm that analyzes stock-research providers, to identify the top-performing firms, ranked by the profitability of their buy and sell recommendations over the past two years. Two well-known firms, Wachovia Securities and Raymond James, make our list of the

six best research providers. But the four others in our top six are all obscure shops that rely exclusively on proprietary, computer-driven stock-picking systems.

Traditionally, access to research has been a perk of doing business with full-service brokers. But that's no longer the case. Fidelity, for example, offers analyst reports from a dozen providers to its brokerage clients. Most other discount brokers offer reports from at least a handful of research firms.

The increasing availability of research owes much to a 2003 legal settlement that penalized 12 Wall Street brokerages for issuing conflicting advice during the stock-market bubble that began in the late 1990s. In addition to assessing roughly \$1 billion in penalties, the settlement required brokerages to pony up \$450 million over five years to supply independent research to clients. Now, for every stock opinion they issue, the dozen brokerages must supply a second opinion. The idea is that independent research will make brokerages think twice before cynically touting a stock in order to land lucrative investment-banking deals.

WHO WON THE RACE

THE PACT ALSO required the 12 big brokers to submit their stock-recommendation data to companies, such as Investars, that track the research providers' records. All told, Investars follows 130 research providers. Among those that don't supply data are Morningstar and *Value Line Investment Survey*, which cater primarily to individuals (see "Advisers for the Masses," on the last page). Also not rated were Charles Schwab's picks, which scored well in a recent ranking of brokerage model portfolios conducted by a rival of Investars. The rankings here exclude those firms and others that don't make their data publicly available.

Investars ranks a firm on the performance of a hypothetical \$10,000 portfolio of stocks for which a firm has issued buy and sell recommendations. (Stocks rated sell are sold short, which means the hypothetical portfolio gains when they fall in price.) We limited the field to companies that cover 500 or more stocks, which encompasses most of the best-known research outfits. We picked a two-year ranking period because data from many independent firms became available about the time that the Wall Street money began flowing their way in 2004.

There is a danger, of course, in using such a short time period. Market conditions over the past two years may have favored the highest-ranked firms. The picture will become clearer with time. And because we focused on research available to investors of normal means, we eliminated from consideration firms that serve only institutional investors and the super wealthy.

We look at the six top-rated companies and some of their recent stock picks. They are listed in order, starting with the best.

Ford Equity Research, the number-one

TOP TO BOTTOM

We RANK the researchers

The 20 firms listed below are ranked in order of the performance of their buy and sell recommendations over the past two years to February 1, as measured by Investars. Only those firms whose research is available to investors were measured.

1.	Ford Equity Research
2.	Raymond James
3.	Columbine Capital
4.	Weiss Ratings
5.	Wachovia Securities
6.	Channel Trend
7.	Citigroup (Smith Barney)
8.	Credit Suisse
9.	Argus Research
10.	Bank of America
11.	Goldman Sachs
12.	Merrill Lynch
13.	Prudential Equity Group
14.	Morgan Stanley
15.	Thomas White/Global Capital
16.	SunTrust Robinson Humphrey
17.	Lehman Brothers
18.	Legg Mason
19.	Rochdale
20.	Standard & Poor's

firm, uses computers to dispassionately evaluate stocks. Such quantitative shops have been around for years, although they are not well-known or easily understood by the public. If their success in these rankings is any indication, they are due a lot more attention.

Ford's proprietary system relies on "a combination of value and growth" elements, says research director Richard

Segarra. The computer model arrives at a stock's value by looking at its historical and anticipated earnings growth, as well as its price relative to similar companies. It then uses a measure of price momentum to verify the attractiveness of a stock. The San Diego firm employs just 16 people and covers about 4,500 U.S. stocks. Ford's research is available to individuals through Banc of America Securities, Fidelity, Merrill Lynch and T.D. Waterhouse.

Among Ford's current buy-rated stocks is **Chesapeake Energy** (symbol CHK), which explores for natural gas primarily in the Southwest and the Gulf Coast region. The stock, recently \$30, has been a favorite of energy investors, particularly since Chesapeake chairman Aubrey McClendon bought more than \$44 million worth of stock (and president Tom Ward bought \$34 million worth) in December and January. Ford also rates financial-services giant **Merrill Lynch** (MER), at \$73, a buy. Although Merrill doesn't rank high for earnings or price momentum, Ford says analysts' earnings estimates are showing a positive trend.

Raymond James is the top-ranked firm that examines stocks the old-fashioned way, with analysts who add a layer of human judgment to their financial calculations. "You can't have a vision of what is going to change on the landscape unless you have somebody down there looking at trends and new competitive factors," argues David Henwood, the firm's chief investment officer. James, based in St. Petersburg, Fla., employs 44 analysts and 42 research associates, and it follows 625 companies, most of them midsize. Its research is distributed to institutional clients and 1.3 million of its individual customers.

One happy Raymond James customer is Chip Gaylor. The 42-year-old trust and estates lawyer in Venice, Fla., uses

the company's analyst reports to help him pick stocks for his own portfolio and for his clients' trusts. "I find that the information and recommendations are useful, and they've been pretty much on the money with their forecasts," he says.

Among recent additions to the firm's Focus List, a collection of its highest-rated stocks, is **Hilton Hotels** (HLT), which plans to merge with U.K.-based Hilton Group to create the world's largest hotel company. Analyst William Crow likes the company's property portfolio in key U.S. business markets and projects 12% to 14% annual earnings growth ahead. The stock, recently \$25, could be worth \$29 in a year, Crow says. Raymond James also gives a strong buy rating to **American Tower** (AMT), an operator of wireless and broadcast communications towers. Analyst Ric Prentiss says the company's strong free-cash-flow growth is beginning to attract investor attention. He says the stock, recently \$31, could hit \$35 in a year.

Columbine Capital employs a mere seven people, but this Colorado Springs quant shop rates nearly 30,000 stocks from around the globe. Its computers evaluate stocks according to a series of value measures and share-price momentum factors, such as a stock's performance relative to the market.

John Brush, 66, who once headed an Air Force research center in quantitative modeling and engineering, founded Columbine 30 years ago. His firm has some 50 institutional clients that pay up to \$150,000 a year. Now that it is providing research for Wall Street customers, Columbine has joined with several other quant shops to hire writers from India to produce reports presenting its data in easy-to-understand terms. Columbine reports are available through Fidelity.

One stock Columbine recently up-

graded to its top buy rating is **Cemex** (CX), a Mexican cement maker that is a play on an explosion in construction in emerging markets. In Columbine's model, the stock's 56% advance over the past year, to \$59 in mid February, is a big plus because it confirms other factors in Cemex's favor. Among them: a price-to-book-value ratio of 2.4, which is a reasonable valuation compared with other stocks in its sector. Another top-ranked stock is **SkyWest** (SKYW), a profitable airline that flies regional routes under contract to major U.S. carriers. Columbine gives the stock its top ranking for forecasted earnings yield (estimated earnings divided by price, or the inverse of the price-earnings ratio) and calls the stock, at \$28, "greatly undervalued."

Weiss Ratings has long been a familiar name to life-insurance buyers, who rely on the firm's safety ratings. Weiss added stock ratings in 2001 and now offers buy, sell and hold opinions on 6,000 stocks, as well as a letter-grade safety rating (A through F). The Weiss system is quantitative, weighing 60 factors, including a company's financial stability, says chief executive Bruce Fador. Weiss provides the ratings to customers of Wall Street brokerages, including Merrill Lynch, as part of the 2003 settlement, but it also offers them to consumers online at www.weissratings.com for \$559 a year or \$15 per report.

Among its recent recommendations is **Cisco Systems** (CSCO), the networking colossus whose shares have been stuck in neutral for years. Weiss says Cisco's recent purchase of TV set-top box maker Scientific-Atlanta demonstrates the company's resolve to become a force in linking television and computer technology, a strategy that "could reap huge rewards." Cisco trades at \$20. Weiss is also high on software giant **Oracle** (ORCL). Weiss contends

that the stock, at \$13, is unreasonably depressed by concerns that Oracle will have a hard time integrating Siebel Systems, which it recently acquired.

Wachovia Securities joins Raymond James as the second representative of traditional stock analysis among the six top firms. The Richmond, Va.-based brokerage unit of banking giant Wachovia employs 40 senior analysts and tracks 950 stocks. The research is distributed through 719 retail brokerage offices and to institutional clients.

Recent additions to Wachovia's Focus List, a collection of its best ideas, include **Illinois Tool Works** (ITW), a manufacturer of a myriad of industrial products. Analyst Julie LaPunzina likes ITW's strong balance sheet—"almost too good," she says—and the potential for some of its businesses to prosper as the economy enters the late stages of the current expansion. She values the stock at \$105, well over its current price of \$85. Also on the Focus List is **Centene** (CNC), which operates managed-care health plans in seven states. Analyst Matt Perry says that Centene's P/E is about 20% below its average P/E in recent years and that the stock, recently \$26, is worth as much as \$31.

Channel Trend is yet another small firm with a potent quantitative model. Founded in 1982, the Dallas firm covers 9,000 U.S. and foreign stocks with a staff of just six. Channel Trend's methodology is a blend of two models, one that measures a stock's value and another that looks at price momentum. Although it may seem that quantitative research firms all use the same model, each has its own approach to choosing how to measure such things as value and price momentum and deciding how to weight the factors. "We all take different approaches, but they all are based on a systematic and disciplined process," says Bill Keller,

one of Channel Trend's four principals. Investors who are used to seeing 12-month target prices should take note of Channel Trend's relatively short-term outlook. It projects prices three months out. The firm's research is available to customers of Banc of America, Fidelity and Merrill Lynch.

Stocks recently upgraded to Channel Trend's highest rating include **Alexander & Baldwin** (ALEX), a Honolulu-based conglomerate with interests in ocean tankers, real estate and food products. The company has been the beneficiary of strong economic growth in China and Hawaii. Channel Trend pegs the stock's fair value at \$57, compared with a recent price of \$48. Another top-rated pick is **Lamar Advertising** (LAMR), which puts advertising on billboards, bus shelters and other outdoor venues. Although the company's results have been inconsistent, Channel Trend gives the stock good marks because its price trend is stronger than most of the stocks the firm follows and better than all of the advertising stocks it tracks. Channel pegs the stock's fair value at \$54. It recently fetched \$47. ■

MORNINGSTAR AND VALUE LINE

Advisers for the MASSES

You won't find two well-known stock-research firms, Morningstar and Value Line, in the Investars rankings. Why? Investars' rankings are primarily for the benefit of big institutions, such as pension and mutual funds. But Morningstar and Value Line aren't competing in that arena. They sell their research directly to individual investors. (The online version of *Value Line Investment Survey* costs \$538 a year; Morningstar's online service costs \$135 and includes mutual fund research as well.) So how can you tell whether their stock picking is up to snuff?

Both firms are tracked by *Hulbert Financial Digest*, which has been monitoring newsletters' stock picks since 1980. The Hulbert performance data won't tell you how well Morningstar and Value Line did compared with research firms ranked by Investars. But it will tell you whether the two stock-picking services consistently beat the market over time. And, in fact, both firms' stock picks have outpaced the market over the past five years.

Morningstar StockInvestor newsletter offers two sets of picks: a safety-oriented "tortoise" portfolio and a more aggressive "hare" portfolio. From July 31, 2001, when Morningstar launched the portfolios, through the end of 2005, the tortoise portfolio gained an annualized 9%, and the hare portfolio was up 5%. Both beat Hulbert's benchmark, the Wilshire 5000 index, which returned 4% annualized over the period.

Value Line Investment Survey, which has been published since 1931, has the second-best performance record of all newsletters Hulbert tracks, going back to 1980. More recently, the four portfolios in the Value Line newsletter returned an average of 7% over the five-year period through the end of 2005. The Wilshire 5000 gained an annualized 2% over the same period.