Corporate research: Many miles to go

By HEMINDRA HAZARI

CORPORATE research is in vogue. Brokerage houses and merchant banks are creating or expanding their research departments as the Indian financial market is in the threshold of tremendous growth. With the granting of permission for private sector mutual funds, research departments have suddenly flourished and become fashionable. Traditionally, investment managers have relied on insider information and luck to outperform the market. However, the new SEBI guidelines should hopefully curb the practice of insider trading and as luck cannot hold forever the responsibility will lie with research departments to outperform the market.

Corporate research in India has long been restricted to an academic arena and has languished in the backrooms of brokerage houses and merchant banks. Management traditionally regarded research as a cost centre which did not warrant additional financial or manpower commitments, as no tangible profits were generated by research departments. Consequently there exists no experienced cadre of business related reasearch analysts in the merchant banking and brokerage sectors. The existing research cadre can be viewed as the first generation of research analysts. Proper training of this generation is therefore paramount as they in turn will influence subsequent cadres of research analysts.

The importance of research and its contribution to performance should not be underestimated. Michael Milken's initial success in America highlighted the importance of corporate research as documented in 'Connie Bruck's *The Predator's Ball.* Milken adopted the research of W. Braddock Hickman, who studied "the corporate performance of bonds from 1900 to 1943 and found that a low-grade bond portfolio, if very large, well diversified and held over a long period of time was a higher yielding investment than a high-grade portfolio". While the low-grade portfolio suffered more defaults the high yields realised compensated more than the losses. Thus Milken revolutionised the U.S. financial system by creating the junk bond market, adopting and augmenting Hickman's research study.

In the West a plethora of applicable investment theories and strategies such as the capital-asset-pricing model (which created the beta risk factor), the arbitrage-pricing theory and the Black-Scholes option-pricing model transformed the financial markets and led to the growth of futures, options and swaps. The advent of faster, cheaper computers with larger databases has facilitated qualitative research. *The Economist* of December 5, 1992 cites other examples where computer models have been able to unearth predictable patterns such as the "January-effect" where the shares of small companies outperformed the market in January. The "turn-of-the-month effect shows that all "prices tend to rise by more than average on the last trading day of the month and on the first three (days) of the new month". While these and other computer aided patterns may not have a rational explanation, trading on them has bought investors higher than market returns. These academic studies have proved the commercial viability of corporate research by taking it from the lofty towers of academia to the lowlands of the trading floor.

Corporate research in India is in a nascent stage. Higher echelons in management have ambiguous objectives for research. They are unclear whether research should play an independent role or serve as a captive unit to provide in-house information for the other corporate departments. Sometimes merchant banks use the research departments to promote the activities of the more profitable issue structuring department. In such cases a "buy" recommendation on specific companies is provided based on biased data to support the management's decision. The clients gain by getting the issue subscribed, the merchant bank gains by having a successful issue and a substantial fee but the subscriber to the issue may lose if the price trades at a lower level in a short period after listing. Brokerage houses also tend to take individual positions in scrips and then use their research departments to support and publicise the companies so that others may follow and then the broker can secure his position and make a profit. This is all achieved in the name of research.

Academic studies have proved the commercial viability of corporate research by taking it from the lofty towers of academia to the lowlands of the trading floor.

Merchant bankers and brokerage houses tend to guage the importance of their research departments by the number of MBAs, CAs and economists employed and by the periodical reports produced with the aid of modern software packages. Unfortunately, corporate research is currently interpreted as reproducing and duplicating existing material. Research analysts tend to rely excessively on secondary sources not withstanding availability of primary sources of data. Even when studying secondary sources no attempt is made to evaluate the information. Critical analysis of large companies is discouraged. Normally a "good" corporate research report consists of praise of the company and its management as adverse comments might invoke the wrath of the subject company. This approach reduces research to a mere public relations job. A long term fallout of such a strategy is that research analysts become indoctrinated against critical evaluation. A research analyst must be able to critically analyse. Companies being image conscious naturally tend to emphasize and over rate their strength while not revealing their weaknesses in their published reports. A research analyst must be able to present a relatively balanced view including that of a company's weaknesses..

Another excercise of research departments is to produce data banks on companies. This normally gives a three to five year financial history, alongwith numerous ratios of various prominent companies. While such compilations are informative as they give brief activities of the company and their respective industries the information produced by different research departments tends to be similar and repetitive. Financial figures and ratios are important but can be easily calculated by computers, a research analyst's skills and abilities are for providing an analytical commentary by interpreting significant data and relating consequences of the financial data presented with future events.

Research departments tuned towards stock market investments first concentrate on the respective industries and study current and future demand/supply, raw materials and power availability, the fortunes of the end users, tariff policy, government regulations etc. and then analyse the concerned companies in the industry. While the industry is comprehensively studied the company's financial analysis tends to be inadequate as excessive importance is given to profits and ratios. Ratios have limited importance and are useful for inter year and inter company comparison but cannot provide an insight into the future. Profits due to the prevalence of accrual accounting contain paper profits which most analysts tend to ignore. Typically, a company's market share, sales, profits, profit margins, sales and profit growth, sales and profit projections and capacity utilisation alongwith numerous ratios are presented. The company's future plans are taken from the Director's Report and from press cuttings. The annual report of a company contains a wealth of information that can be analysed and interpreted. However, the full potential of the balance sheet, the profit and loss account and the notes to the accounts have not been successfully exploited by research analysts. Extremely vital information which guage management capability like cash flows, investment of surplus liquidity, the ability to raise short and long term debt and the company's tax planning is virtually ignored. This information is important because it reveals how the management has planned for the future years and therefore the research analyst can estimate the company's short term and long term performance regardless of how the industry performs.

Currently, corporate research in merchant banks tend to emphasise equity and stock market related research. However, the potential for research is tremendous — the debt market which is much larger than the equity market has been grossly under researched. Economy research which so far has been the preserve of government agencies and academic institutions can also be explored by merchant banks. With the opening of the Indian economy, Indian merchant banks and brokers will face intense competition from their foreign counterparts who have greater exposure to finance and have more experienced research department. Already valuable country reports on India are being produced by foreign brokerage houses and other consulting firms.

It is therefore paramount that the senior management of Indian merchant banks and brokerage houses have clear and distinct objectives for research. There is need for adequate training and guidance as most of the managements have been unable to operationalise their research departments. If successfully deployed research can be the power engine that will drive the locomotive of investments in the capital market.