

ON COMMUNICATION BETWEEN BROKERS, RESEARCH
ANALYSTS AND INSTITUTIONS

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Many people will recall the book and motion picture about the humorous adventures of a migrant to Australia, and his problems of communication. I recall with amusement my own bewilderment when I first arrived on realizing that I could not understand "Australian" as spoken. The problem of choice between different channels of communication is known to us all.

It is with these thoughts that I propose a two-stage system of broker reporting to institutions - firstly, the distribution of the written study and secondly, the personal talk with the purpose of defining frames of references, assumptions and areas of conflict of opinions.

Broker Reports and Institutional Needs

It seems to me that the primary objective of an investment report is to bring out the salient features pertinent to a security by which a portfolio manager can weigh the risks and potential returns of the security. We all know that each portfolio operates on a different risk/return frontier but most importantly the measurement of risk and of potential return is a highly subjective matter.

It is extremely difficult to define the area and nature of the risks in the revenues and various expenses of a company. We try to do this through an analysis of the micro-economic environment, inquiries into the company's marketing-mix, sensitive or unstable cost areas, such as labour, raw materials, power supply etc. and of course financial policy.

We try to obtain as much statistical data as possible to enable us to reduce the subjective element in translating the above enquiry into risk measurement, but the available data is wholly inadequate.

Not only must we cope with the measurement of risks inherent in a company's earnings performance, but we must also consider the risk preferences of the market.

Thus the institutional clients may be least inclined to invest in developers with extremely low yields as most institutions are already heavily invested in property and property-related stocks. However, should mortgage rates and property investments decline, the institutions proportionate holdings in property may be reduced and in the process make them more favourably disposed towards acquiring the higher risk and higher potential return stocks of developers.

In all these we have to rely heavily on subjective assessments. If we take the frozen vegetables business as an example how do we present the probabilities that price wars are over and that pricing policies will now allow for profitable operations?

What probabilities can we assign to the various price magnitudes?

Unfortunately, we are only too familiar with the lack of time allowed to us in company interviews, besides the reluctance of corporations in giving data which often is available to their competitors. An analyst therefore finds himself resorting to general statements like "we expect prices to stabilize to profitable levels". In communication this statement and translating it into earnings and growth figures along with the margin for error in such a conclusion, the analyst is not in a position to transpose his "judgment process" into his report.

To communicate this "judgment process" we have to resort to personal contacts with our institutional counterparts.

I think the institutions should encourage the development of personal reporting through a critical appraisal of the relevant data and the judgment process. I say "appraisal" because it is so easy for us to lapse into a situation where we are trying to impress each other with our own command of the facts and of our abilities, instead of assessing each other's "judgment processes" and making a decision as to whether the assessment of the security's risks and returns are sound.

We each have our own style of communicating but I think it is important that the personal report should appraise data stated in the written report, and also data which the institutional analyst may think is relevant and left out. The broker's analyst may have reason for leaving out the data.

Effort and Reward Criteria

I think it would also be worthwhile for most institutions to encourage an unbiased approach (if this is possible) by awarding orders on stocks other than the one reported on. In this way the analyst would still have to sell his service but does not have to take an opportunistic approach, by disagreeing if he knows that an institution values his service less if they arrive at similar conclusions or by agreeing with them because he feels that institutional members do not encourage differences of opinion.

We know that excellent research service can be rendered even if we agreed on the merits or demerits of a stock and used the same approach at arriving at our conclusions. The approach need not be novel or any new information given - the service needs only to be of high quality reflecting a highly professional approach.

Brokers' Reports and Current Interest of Institutional Managers

Due to differences in timing policies and the portfolio-mix of an institution at any given time, it is natural that an institution's current interest will to a large extent differ from the particular stock which the broker is reporting on.

If the institutional manager can spare the time it would, in my opinion, be still worthwhile going through the report with a personal interview to assess any changes in the risk/return potential of the stock.

It is also comforting to brokers and institutions to know that even if a report is distributed to all the institutions a buying and selling decision can often still be made based on the report due to the difference in timing and risk/return criteria policies.

Conclusion

I think the more comprehensive two-stage process (of written reports followed by a personal report) of investment advising (as we call it) will be used more often rather than the "idea" or "tip" basis which is still somewhat in use.

In my opinion, unless the advice given makes the portfolio manager aware of all the risks in a particular security, the investment decisions made could be disastrous to the portfolio. Of course, if a potentially profitably "idea" is transmitted along with a whole set of information covering the risks of the security, it would seem to me to be high-powered advice.

I think there is room for improvement not only in the quality of advice given but in our choice and use of channels of communication.

